Constructing Representations of Risk in Regulatory Networks

Accounting for Financial Instruments

David Borger

A thesis submitted to the
London School of Economics and Political Science
for the degree of Doctor of Philosophy in Accounting and Finance

October 2000

ProQuest LLC
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106-1346

Declaration

No portion of the work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or institute of learning.

Acknowledgments

This thesis was written during my time at the London School of Economics and Political Science, between September 1996 and May 2000. The idea to study accounting regulation for financial instruments came in discussions with Michael Power, who acted as supervisor for this thesis. Many of the ideas presented here are the result of the discussions we had during the last couple of years. Encouragement to conduct a case study based on a series of interviews with experts came from Peter Miller, who also supervised me during certain periods of my research. I am extremely grateful to both of them for their patience during my frequent detours and their encouragement to undertake this research and eventually write this thesis.

I am indebted to many people in Europe and North America who offered their valuable time to speak to me about accounting for financial instruments in interviews and in many other informal discussions throughout the years 1998 and 1999. Most of what is written in this thesis came to rely on the willingness of experts in many different institutions related to accounting standard setting to share their views with me.

While working on this research, I was in the privileged position to be a member of staff in the Department of Accounting and Finance at the London School of Economics. I was first granted the position of a Tutorial Fellow and, from September 1999, I came to work as a Temporary Lecturer. During the last two years of working on this thesis, I was a recipient of the LSE Barclay Studentship. The generous intellectual and financial support by the Department, the School and the Trustees of the Barclay Studentship allowed me to concentrate on this research project more intensively than I could otherwise have done.

The many research seminars and the lively intellectual debates in the Department allowed me to become immersed with current thinking in accounting regulation and areas of regulation closely associated with it. Many members of the Department regularly commented on preliminary versions of the thesis and challenged my conclusions. Apart from my supervisors, I am indebted for thorough comments on specific chapters of this

thesis to Thomas Ahrens, Michael Bromwich, David Cairns, Alex Lopes, Carlos Ramirez and Anna Yip. Furthermore, I received helpful comments and feedback on specific chapters from participants in the Doctoral Seminar of the Department of Accounting and Finance at LSE.

A paper based on chapter three was presented at the University of Edinburgh in October 1999 and a later version of this chapter is currently under review. Thanks for comments on this paper need to go to Anthony Hopwood and two anonymous referees. Earlier versions of chapter five were presented at the University Witten/Herdecke in Germany and at the PricewaterhouseCoopers Doctoral Colloquium in May 1999 in Arcachon, France. Thanks for helpful comments during the latter go to Ray Ball, David Cooper, Dieter Ordelheide, and Stephen Zeff. A paper based on chapter five, which I presented in Witten/Herdecke, was subsequently published in German language in the journal Soziale Systeme (Borger 1999). I received additional feedback on this German version from Dirk Baecker, Joachim Behrendt and Michael Hutter. All remaining errors, of course, are my own.

London, October 2000 David Borger

Abstract

The extant literature on accounting regulation in the context of private-sector standard setting has mainly focused on lobbying by means of comment letters. Some rather casual while interesting accounts of the process of standard setting 'behind the scenes' by former insiders and by close observers have complemented this research. Only few detailed studies have looked at how accounting standards emerge over time and in the wider social context. After theory had become deconstructed as providing excuses in the late 1970s, few contributions have looked at the role accounting theory plays in accounting regulation. To analyze the process of accounting regulation in more detail with a focus on the conceptual foundation and the social context of accounting, this thesis looks at one particular international standard setting project that took place over a period of ten years.

The thesis focuses on the International Accounting Standards Committee's (IASC) project on financial instruments that was inaugurated in 1988 and resulted in a comprehensive recognition and measurement standard by the end of 1998. Because of the nature of financial instruments, which came to challenge traditional accounting concepts and did not fit easily into existing accounting categories, the project ventured into hitherto unknown regulatory territory. In the process, some of the premises of financial reporting became transformed, in particular with respect to the representation of financial risk. Due to the esoteric nature of the object of regulation - financial instruments - and the intellectual challenges involved, the regulatory debate came to sustain a high level of conceptual independence. Within the debate, new notions of appropriateness of problems and solutions emerged in reliance on a close international network of experts, organizations and ideas. However, legitimately shifting the boundary of what accounting can and should represent became a considerably demanding endeavor, as it was resisted in reference to traditional meaning of accounting. While slowly emerging notions of what accounting can and should represent helped to justify the new accounting guidance, conflicting notions of appropriateness remained resilient.

The thesis contributes to refining a model of regulation and accounting standard setting as a regulatory debate that is structured by a meaning-reproducing network of experts, organizations and ideas. Some of the policy and theoretical implications of the study relate to the regulatory role of conceptual frameworks in supporting notions of appropriateness. It also sheds light on notions of regulatory independence, which became prominent in recent proposals for reforming the international standard setting regime. In particular, the structure of the debate was seen to put considerable constraints on pace and direction of regulatory change. Furthermore, the case suggests that the success of regulatory initiatives may depend more on the success of shifting notions of appropriateness of problems and solutions and the meaning given to accounting than on the power and persistence of lobbyists.

Contents

Tables

Page

Figures

Page

CHAPTER ONE:

Introduction

Introduction

By the end of 1998, the International Accounting Standards Committee (IASC) issued accounting guidance on recognizing and measuring all financial instruments - just in time, it seemed, to start into the new millennium with a complete set of accounting standards. At the same time, proposals were published to restructure the international regime for financial reporting regulation. In 1997, a Strategy Working Party had been formed. After one year, this working party came to suggest far reaching amendments to the IASC's membership, its operating procedures as well as its relationships with the accounting profession and with national standard-setters.[1] The two events seemed to be related. In particular, the financial instruments seemed to be a test case for international collaboration in standard setting as well as a test case for IASC's ability to independently develop credible accounting standards.

Independence of the impending international standard setting body became the key issue in discussing IASC's restructuring. The Financial Accounting Standards Board (FASB) of the United States (U.S.) became seen as the model of a formally independent standard setter. However, even in the case of the U.S., formal independence had emerged only over time and is still being challenged. In the 1930s, when the newly established Securities and Exchange Commission (SEC) was granted the statutory authority for accounting regulation, it soon came to rely on private-sector bodies for specifying how firms should report their financial position and performance. Initially, the part-time bodies in charge of this codification task consisted of practitioners and academics under the umbrella of the professional body, the American Institute of Certified Public Accountants (AICPA). Only by 1973 was the Accounting Principles Board (APB) of the AICPA replaced by the FASB, which came to formally operate at some distance from the profession. FASB was construed as a full-time independent standard setting body, whose seven Board members were drawn from senior

[1] The discussion paper and most of the over 80 comment letters submitted in response are available for download from the IASC web site at http://www.iasc.org.uk. The debate about the future of the IASC took place in the context of countries such as Germany and France establishing standard setters and thus moving closer to a model of accounting regulation that had emerged in Anglo-Saxon jurisdictions.

positions in public accounting, industry, academia, the financial community, and government. They worked for renewable five-year terms compensated commensurately to positions in industry instead of acting as delegates of the profession or as representatives of particular interest groups (Miller et al. 1998).

Meanwhile, the need for a body like FASB to be independent from the profession was seen to emerge with the rise of more controversial accounting standards. Particularly with the notion of 'economic consequences' that had given rise to the belief that accounting regulation under the control of the profession might have become prey to third party intervention and political haggling (Zeff 1978). For instance, in the early 1960s in the context of accounting for investment credit, economic consequences had been employed as a powerful political resource. Increasingly, preparers and other outside parties had come to realize that accounting may be a variable and that the rules of accounting were 'not unyielding or even unbending' to intervention. Eventually, the fall of the APB became seen as a result of inappropriately dealing with external intervention.[2]

While one aspect of independence concerned the standard setter's relationship with the accounting profession and lobbyists, another aspect concerned the relationship between the legal responsibility for accounting regulation and the standard setting process itself. In the U.S., the SEC soon came to accept pronouncements by the standard setter as carrying quasi-legal power without direct intervention in the process of standard setting.[3] In the United Kingdom (U.K.), a similar sharing of responsibilities emerged between arbiters of law and standard setters (Bromwich and Hopwood 1983; McBarnet and Whelan 1999). U.K. law made no explicit reference to a particular organization to develop standards. However, it included the so-called true and fair override, which was first encoded in Company Law in

[2] In a similar way, the U.K. Accounting Standards Committee (ASC) did become discredited as a result of intervention by interested third parties (Bird 1984). In 1990, it came to be replaced by the formally more independent Accounting Standards Board (ASB).

[3] Under its Accounting Series Release No. 150, the SEC considered standards and interpretations issued by the FASB as having 'substantial authoritative support' and those in conflict with FASB promulgations to have no such support. In 1980, the SEC codified its position that financial statements filed with the Commission that are not prepared in accordance with Generally Accepted Accounting Principles (GAAP) would carry the presumption to be misleading unless the Commission provided otherwise (Zeff 1995).

1947. As Arden (1993) pointed out, the true and fair requirement was a question of law for the Court. However, the task of interpreting the true and fair requirement could not be performed by the Court without referring to the practices and views of accountants. The more authoritative those practices and views were, the more ready would the Court follow them. It was therefore likely that the Courts would hold that compliance with accounting standards was even necessary to meet the true and fair requirement. The immediate effect of an accounting standard was that it improved the likelihood that the court would hold that compliance with that standard was necessary to meet the true and fair requirement. The likelihood was strengthened by the degree to which a standard was subsequently accepted in practice.

Still, another dimension of independence - and the one that is of particular concern in this thesis - concerns what we may refer to as *conceptual independence*. There has long been an understanding that accounting regulation needed to consider conceptual tradeoffs between, for example, relevance and reliability. It was in the sense of establishing firmness in balancing these conceptual tradeoffs that conceptual framework projects were seen to strengthen the independence of accounting standard setters. And although the conceptual underpinnings of frameworks have been challenged repeatedly (Macve 1983; Solomons 1986; Power 1993; Archer 1997), conceptual independence of the regulatory debate seems to have gained in significance over the last decade, as becomes obvious in more esoteric projects such as the one on financial instruments.

Despite formal independence of standard setting - in the U.S. from 1973 with the establishment of the FASB and in the U.K. from 1990 with the setting up of the Accounting Standards Board (ASB) - there was continuing evidence about attempts to influence standard setting through lobbying by constituents (Zeff 1997). Independence in the presence of lobbying came to be an issue of public and academic concern. Critics argued that the accounting profession, large accounting firms and constituents had been able to influence the FASB's standard setting process (US-Senate 1977; Johnson and Solomons 1984; Zeff 1993; Beresford 1997). The latest and arguably severest challenge to the FASB's formal independence was in 1997, when members of Washington's political establishment tried to

prevent the proposed standard on derivatives and hedging activities by challenging the FASB's jurisdiction (Davis 1998). Financial instruments thus became seen as one of the severest tests of the FASB's independence to date.

As a result of interference of this kind, there has been a long-standing academic view that the process of accounting regulation involved political bargaining. Research has come to argue that in a number of cases lobbyists have successfully influenced the standard setter to have exposure drafts changed. Meanwhile, the respective research in accounting regulation has mostly focused on the political dimension and has come to model accounting standard setting as a process of lobbying by interested agents. Analyses adopting this perspective have significantly contributed to our understanding of lobbying in specific cases of standard setting.[4]

Meanwhile, a closer look at the history of standard setting suggests that the overall *success* of lobbying on standard setting remains difficult to establish (Sutton 1984; McLeay et al. 2000). More recently, some of the victories of lobbyists may have become rather short-lived. In some cases where lobbying was seen to be successful initially successive changes to accounting standards came to reverse the balance in favor of regulators.[5] It seems that, in the longer run, and even more so in recent years, the outcomes of accounting debates have been less responsive to external pressures than many observers imagined. The ASB came to publish its conceptual framework, despite fierce lobbying by accounting professionals. The FASB eventually did go ahead with its proposed standard on financial instruments, despite political meddling by banks and banking regulators.[6] Likewise, the IASC came to publish its standard on financial instruments, International Accounting Standard (IAS) 39, despite considerable resistance from some of its members and constituents.

The research presented here addresses the issue of independence of the standard setting

[4] See, for example, Walker and Robinson (1993) for a review.

[5] This point would clearly demand more research. The obvious recent example concerns the U.K. standard FRS 5 on the substance of transactions. Here, the standard setter was seen to successfully introduce a standard against substantial opposition while effectively reducing reported instances of 'creative compliance' (Shah 1996; McBarnet and Whelan 1999).

[6] Of course, it remains to be seen whether SFAS 133 will be implemented as originally issued. More on this further below and in the conclusion.

process and the question of how standard setting prevails in conditions of considerable lobbying. While focusing on the particular case of the IASC's financial instruments project, this thesis tries to contribute to our understanding of the process of accounting regulation by looking specifically at the conceptual dimension of accounting regulation and the way accounting regulation draws on different bodies of knowledge, experts and organizations. It thus aims at making a contribution to a research tradition that has come to analyze the *process* of accounting regulation from a social perspective (Burchell et al. 1985; Hopwood 1987; Power 1992; Robson 1994b; Young 1994).

This thesis analyzes accounting regulation under two epistemological assumptions. First, accounting is *not* a neutral technology for making firm value and risks visible. Rather accounting needs to be understood as a technology, which creates visibility and constructs the categories of reality it sets out to represent (Hopwood 1987). Second, accounting regulation takes place in a *social context.* Accounting regulation becomes subject to competing and shifting understandings of what accounting can and should represent, which neither standard setters nor constituents can fully control. It is further subject to conflicting claims to such representations by different bodies of knowledge, constituents and agencies of the state. Accounting not only constructs categories for making things visible. Rather, in justifying accounting guidance, accounting regulation invokes notions of appropriateness of accounting problems and solutions that conceptually outline the boundaries of what accounting can and should represent and thus construct its 'margins' (Miller 1998).

Any proposed way of accounting representation involves selectivity, which can be seen to have intended and unintended effects. Meanwhile, debating selective ways of representation involves justifications. Whether excuses or not, such justifications can be seen to rely on premises about the role of accounting. These premises can be regarded as the meaning given to accounting in the sense that they inform notions of appropriateness of accounting problems and solutions. These premises can be analyzed by the way they suggest constructing accounting objects and reporting entities and they can be analyzed by the way they come to change over time. The premises of accounting representation, also referred to as notions of appropriateness, are the objects of analysis presented here. The theoretical

foundations of this analytical perspective will be discussed further below and in chapter two.

The case reported here - the attempt to develop international accounting standards for financial instruments - suggests that external parties do indeed become involved in the regulatory process. However, they appear to be severely limited in their endeavor to influence outcomes of the regulatory debate. This appears to be even more the case, the more the debate becomes conceptual and becomes framed by persistent *notions of appropriateness* (March and Olsen 1989; Young 1994) that are supported by strong networks of experts, organizations and concepts (Latour 1987; Miller 1997). The regulatory debate seems to resist intervention by lobbyists to the degree that such networks support specific notions of appropriateness. This also means that any regulatory initiative appears to face considerable resistance from *incumbent* and *competing* notions of appropriateness of what accounting can and should represent (Singer 1990; Power 1992). Incumbent notions of appropriateness are thus seen to limit the scope as well as the speed of the regulatory change.

Some findings of this research are likely to be specific to the particular case of financial instruments. Financial instruments were new and the resulting debate had to rely on conceptual guidance more than other regulatory debates in accounting. Nevertheless, the analysis of international regulation of financial instruments presented here may contribute to our understanding of the way in which regulatory debates in accounting take place, even when discussing issues that are less esoteric than financial instruments. The case illustrates how emerging notions of appropriateness of accounting problems and solutions were being referred to in the regulatory debate; how they changed over time; and how they became resisted.

While they were framing the regulatory debate, notions of appropriateness were seen to be emergent and beyond the direct control of the parties contributing to the regulatory debate. Meanwhile, the research shows how notions of appropriateness come to shift over time with the emergence of new ideas and new accounting techniques. Such shifts can be seen to rely on the specificity of the network of ideas, experts and organizations that supports the debate

and provides legitimacy to emerging accounting problems and solutions. Furthermore, it is through emerging problems and appropriate solutions that the boundaries of the accounting field may be seen to shift.

The remainder of this introduction will introduce some aspects of the regulatory debate on financial instruments that are necessary as a backdrop for appreciating the remainder of the thesis, before discussing the structure of the thesis in more detail. It will discuss some of the challenges arising from the new contractual arrangements that came to be collectively referred to as *financial instruments* in the late 1980s. It will illustrate these challenges in reference to the issue of *hedge accounting*. The section following the next will briefly discuss the specific role that the financial instruments project played in the regime of international accounting standard setting. This introductory chapter closes by providing an overview of the other chapters of this thesis.

Financial instruments: hedging or speculating?

The case of financial instruments is of particular interest for accounting. Like some other accounting issues such as brands and inflation accounting before, financial instruments have been seen to challenge fundamental principles of accounting. Financial instruments came to challenge traditional principles for recognition and measurement of assets and liabilities, as well as established distinctions between accounting categories. Some of the innovative instruments that appeared during the 1970s and 1980s were seen to have characteristics of both debt and equity (convertible debt) or revenue and assets (leasing and securitization), blurring fundamental categories on which the traditional accounting model relied.

Financial reporting traditionally had been associated with reporting of financial position and performance but also with adaptability[7] and financial statements had been considered useful for assessing the risk of companies. However, some financial instruments never appeared on

[7] For example, the ASB's (1995) proposed statement of principles, par. 1.1 stated: "The objective of financial statements is to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions."

the balance sheet (like forwards and futures) while carrying substantial financial risks. More fundamentally, financial instruments enabled new off-balance sheet technologies for managing financial risk. At the same time, while traditional approaches to risk assessment had drawn on balance sheet ratios, such ratios were rendered less meaningful by financial engineering and hedge accounting. Financial instruments thus became seen to challenge traditional accounting representations of financial risk. When firms increasingly assumed risks not represented on the balance sheet, or in dubious categories, it slowly emerged that with respect to financial risk existing incumbent categories of accounting might not be appropriate.

In the mid 1980s a series of newspaper articles reported that financial derivatives had became more frequently used not only by banks but by corporates as well. At the same time, banks, for example, were seen to allow their customers delaying payment for the option premium until the expiration date by off-setting it against the price paid for the underlying instrument. This practice circumvented accounting recognition of options on the client side - options remained off-balance sheet - and provided credit at the same time. To give another example, in 1985 the Financial Times commented on the use of derivatives by a company called Fisons plc, a maker of medical instruments.[8] The company had insured anticipated foreign earnings by buying put options on the dollar. With this strategy it claimed to hedge more than a specific transaction but rather the broad dollar related accounting profit in terms of sterling. The practice not to reflect the cash paid to obtain the hedge in the profit and loss account, but to defer it for matching with future transactions, became referred to as *macro hedging*. As the article commented, macro hedging of this type had previously been considered appropriate for banks rather than for manufacturing companies. For manufacturing enterprises they were seen as impairing the comparability of financial statements.

A number of articles during 1986 came to discuss the likely implications and challenges associated with the new financial market instruments. For instance, it was argued that the

[8] FT, 23 September 1985.

new money market instruments faced a particular risk in view of inappropriate management information systems and controls. While developments in the marketplace were seen to expand the use of ingenious financial products, management was increasingly facing difficulties in assessing the risks associated with the transactions they were becoming party to. There were no established ways of reflecting the transactions in the accounting records nor were there control systems to monitor the risks throughout the life of a transaction. Swaps, options, futures, caps, collars and the plethora of other financial transactions which, under the prevailing rules, did not appear on an institution's balance sheet, were thus seen to pose challenges for management as well as accountants.[9] To address these challenges, it was argued that accounting firms would need to develop an entirely new set of skills.

Even by 1991, it was pointed out that, for example, U.K. users of financial derivatives still did not find firm guidance on how to account for many financial instruments. Some articles argued that there needed to be improved accounting guidance in the area of derivatives given recurring losses on currency futures by industrial companies. One article for instance argued that with lack of disclosures investors might wonder how many apparently staid industrial companies were running financial sidelines. Prevailing practice was seen to encourage managers to report unsuccessful hedging but not the routinely successful bet. Only if managers needed an excuse for a big loss were they seen to become frank and open. Otherwise, they did not want to let investors think they had lost touch in their core business. As long as hedging improved the profit figures in a way indistinguishable from normal trading, many managers did not seem to mind.[10]

The way the use of financial instruments became depicted in the public arena suggests that it became ever more difficult to determine what risks companies' were exposed to. It further suggests that top management was facing problems in understanding what was going on, in particularly in cases were experts in derivatives were running their treasury function. Neither the existence of derivatives nor the exposure limits were disclosed in financial statements. As some writers suggested, in many cases it was not even clear, why firms were

[9] FT, 27 October 1986.
[10] FT, 25 March 1991.

using derivatives. Only gradually did a professional and academic literature emerge, trying to determine the reasons why firms were hedging (Stulz 1984; Smith and Stulz 1985; Smith et al. 1989; Belk and Glaum 1990).[11] Were firms using derivatives for speculating rather than for hedging? If so, how could one distinguish between speculating and hedging? As another article in the Financial Times pointed out:

> Options ... may be used by corporate treasurers and others to hedge their future currency cashflows - or just to speculate. To their supporters, such instruments have brought new flexibility to the management of financial risks for companies, investors, government agencies and others. To their critics, they have opened a Pandora's box, creating complex risks that few users and traders of derivatives know how to handle.[12]

Concerns about hedge accounting as a disguise for speculation were ameliorated by the adoption of two conflicting accounting standards on hedging in the U.S., which were also informing practice in those jurisdictions that did not have dedicated hedge accounting guidance. In the early 1980s, the U.S. standard setter introduced guidance for foreign currency translations, Statement of Financial Accounting Standard (SFAS) 52 issued in 1981, and for futures contracts, SFAS 80 issued in 1984. Resulting from different underlying concepts of risk and risk reduction basis, exposures of recognized transactions in SFAS 52 and exposure of the enterprise in SFAS 80, these standards proposed conflicting principles for hedge accounting (Stewart 1989).

The ambiguity that existed in the late 1980s with respect to what hedge accounting can and should represent related to an ambiguity with respect to what appropriate risks and risk exposures were. The uncertainty about what types of relationships should qualify as hedge relationships was reflected in definitions of hedges in the authoritative literature at that time. For example, definitions of hedges and definitions of risks to be hedged were summarized by Bierman et al. (1991), published as a FASB Research Report. This report provided a synopsis of the state of the art in hedging as well as on technical questions related to hedge accounting. To clarify the notion of hedging, it reviewed four major dictionaries and

[11] Some of the more recent literature on firms' inclination to hedge includes (Mian 1996; Guay 1999; Hardwick and Adams 1999).
[12] FT, 22 July 1993.

concluded:[13]

> Barron's accounting dictionary and *Webster's* emphasize protection against loss, without reference to partial or complete protection; Barron's finance dictionary and *Kohler's*, on the other hand, both refer to complete protection against the possibility of loss. Barron's finance dictionary and *Kohler's* consider complete reversal of gains to be incorporated in the hedging notion as well. Barron's accounting dictionary and *Kohler's* imply that the risk of loss exists only with a consummated agreement, which seems to preclude anticipatory hedges; Barron's finance dictionary and *Webster's* seem to allow anticipatory hedges. While all four dictionaries indicate that hedges provide protection against price fluctuations, they do not make clear whether that is the only risk to be protected against and how that risk should be interpreted.[14]

This uncertainty about the substance of a hedge transpired to the reflections of Bierman et al. (1991) that attempted to distinguish hedging from other forms of diversification, like portfolio management, and from speculation. The authors suggested that the substance of hedging could be distinguished from other risk-management techniques and speculation by the degree to which the risk reduction *motive* exceeded the motive of increasing the return when entering into the contract or buying the instrument:

> Distinguishing hedging activities from other activities intended to mitigate risk is difficult. Despite that difficulty, a test of whether risk protection is at least as likely as [increases in] expected return is a useful descriptive device to differentiate - at least conceptually - hedging from other risk-mitigating techniques.[15]

What seemed to matter was the way, management *constructed* its exposures and whether it considered the upside as well as the downside. Such an assessment necessarily had to rely on judgment and thus on management's discretion. Bierman et al. (1991) proposed two approaches to distinguish between hedging and speculating without reference to management's intention. One was to introduce classificatory constraints for hedges the other was to require more restrictive measurement guidance. The first approach was seen to involve, for example, a requirement for a high degree of hedging effectiveness before items qualified as hedges. While it was believed that such a threshold might prevent speculative activities from being improperly recorded as hedges, it was feared that it might also fail

---

[13] The dictionaries reviewed by Bierman et al. (1991) included: Webster's New Collegiate Dictionary (1979), Barron's Dictionary of Accounting Terms (1987), Barron's Dictionary of Finance and Investment Terms, 2nd edition (1987), and Kohler's Dictionary for Accountants, 6th edition (1983).
[14] Bierman et al. (1991), pp. 54-55.
[15] Bierman et al. (1991), p. 60.

economically meaningful hedging relationships to qualify. The alternative was to have a low threshold for qualifying hedges but to tighten the measurement criteria, for example, to require hedge and hedged item to be accounted for under mark to market accounting. We will return to this debate in more detail in chapter four.

Meanwhile, attempts to specify the notion of hedging and the types of relationships that should qualify as hedges revealed that underlying these different notions were very different views on the nature of financial risk and exposure to risk. It was these different views that were seen to inform notions of appropriateness of accounting guidance on hedging. For example, a Special Paper issued by the Group of Four plus One (G4+1) (Adams and Montesi 1995) observed that even if hedging was conceived as a strategy for reducing risk there existed different interpretations of adverse consequences:

> In that context, *risk* is the possibility that adverse consequences might occur. *Exposure to risk* is the condition of being unprotected against the possibility that adverse consequences might occur. However, different enterprises have different interpretations of adverse consequences. Some consider loss ... to be an adverse consequence. Others consider variability in outcomes, that is, fluctuation in price or cash flow (up or down), to be an adverse consequence.[16]

Different firms were seen to *construct* the risk they were exposed to in very different ways. As the study found, different conceptualizations prevailed of what financial loss was and what the consequences for risk exposures were. Financial institutions were seen to view their risk exposures in terms of a potential mismatch of their assets and liabilities and its effect on the net interest income. Other firms were seen to construct their exposure to risk in relation to possible changes in the market value or price of an item. Others just considered exposures to future cash flows resulting from interest rate changes.

As a result, considerable regulatory uncertainty prevailed as to what types of financial risks can and should be considered for hedge accounting: credit risk, foreign exchange risk, interest rate risk, liquidity risk, market risk, etc. Subsequent accounting proposals on hedge accounting came to emphasize different components of risk as well as risks of different sub-components of complex financial instruments. Only by the mid-1990s did new notions of

[16] Adams and Montesi (1995), p. 1, original emphasis.

risk representation emerge. Instead of considering the *source* of risk - which had yielded the classification of financial risks into credit risk, interest rate risk, foreign exchange risk, etc. - the debate came to focus on the expected financial *effect*. Two aspects of the financial effect came to matter: the future flows of cash and the present value of cash flows, or market value. In reference to these two aspects did the Adams and Montesi (1995) paper attempt to synthesize different views on risks: a *cash flow* perspective and a *market value* perspective. These two perspectives came to be seen as informing notions of appropriateness about different forms of hedge accounting and it was in this way that hedge accounting did come to raise more general questions about the accounting model used for financial instruments. In line with these models, two different techniques for hedge accounting were considered. One was a pure mark to market approach and the other was referred to as deferral hedge accounting. Both approaches derived from accounting practice and both were encoded in the two conflicting U.S. standards mentioned above (Evans and Doupnik 1986b; Griffin and Castanias 1987).

In order to illustrate the two ideal-typical views on financial risks and their impact on the two hedge accounting techniques, we may consider two identical firms (A and B) that differ only with respect to the way they construct their risk exposures. Contingent on the way they privately construct their risk exposures, we may contrast the different hedging strategies that each firm might be seen to adopt. Let us assume that both firms hold a 2-year £100m debt security with a fixed rate coupon of 8% (fixed at LIBOR+2%). Both are financed by a 2-year £50m debt security, which has a floating rate LIBOR+1%, as well as £50m in equity. To start with, LIBOR may be at 6%. Let firm A construct financial risk in terms of contingent future *cash flows* and let firm B construct financial risk in terms of contingent future *market values*. Let us further assume that there is uncertainty as to the future direction of LIBOR: at the end of year one/beginning of year two, LIBOR may be the same, or it may increase or decrease by 1% respectively. Otherwise, to simplify the illustration, we may assume a flat yield curve and a fixed risk premium.

Table 1.1: Expected effects of changes in LIBOR on firms A and B

		Expected change in LIBOR after one year		
For year two (in £m)		no change	1% increase	1% decrease
Asset:	Market value start of year[17]	100.0	99.1	100.9
	Cash flow end of year	108.0	108.0	108.0
Liability:	Market value start of year	(50.0)	(50.0)	(50.0)
	Cash flow end of year	(53.5)	(54.0)	(53.0)
Total exposure:	Market value start of year	0.0	(0.9)	0.9
	Cash flow end of year	0.0	(0.5)	0.5

What will be the hedging strategies adopted by the two firms at the *beginning* of year one? To discuss this, we may consider the expected effects of changes in LIBOR on the market value[18] and cash flows of the instruments as well as on the exposure of the firms as a whole as illustrated in table 1.1. Now, as firm A constructs its financial risk exposures in terms of future cash flows, its hedging strategy during the first year will selectively consider the exposure arising from variability of cash flows of the liability. At the beginning of year one, firm A may therefore buy a 2-year swap that effectively converts the floating rate debt into a fixed rate liability. The hedging strategy for firm A is presented in table 1.2.

Table 1.2: Hedging strategy of firm A

		Actual change in LIBOR after one year		
For year two (in £m)		no change	1% increase	1% decrease
Asset:	Market value start of year	100.0	99.1	100.9
	Cash flow end of year	108.0	108.0	108.0
Liability:	Market value start of year	(50.0)	(50.0)	(50.0)
	Cash flow end of year	(53.5)	(54.0)	(53.0)
Swap:	Market value start of year[19]	0.0	0.5	(0.5)
	Cash flow end of year	0.0	0.5	(0.5)
Total exposure:	Market value start of year	0.0	(0.4)	0.4
	Cash flow end of year	0.0	0.0	0.0

As can be seen from table 1.2, firm A is able to fully offset its cash flow risk by using a swap from floating to fixed interest rates. The strategy reduces variability of outcomes with respect to cash to be paid. Although the swap creates market value risk, it accidentally turns

[17] For example, if LIBOR increases, $PV(\text{asset}) = \frac{£108.0\text{m}}{1.09} = £99.1\text{m}$ (after rounding)

[18] As will be discussed in more detail in chapter four, the notion of market value used here refers to a hypothetical (fair) value rather than an empirical value.

[19] For example, if LIBOR increases, $PV(\text{swap}) = \frac{£50\text{m}(0.8 - 0.7)}{1.08} = £0.5\text{m}$ (after rounding)

out that in the context of this particular firm the hedging of cash flow risk reduces the firm's total exposure to market risk as well. Meanwhile, as firm B constructs its risk exposures in terms of future market values, its hedging strategy will be informed by a selective focus on the expected future market value of the asset. Company B might therefore sell an appropriate number of 1-year Treasury bond futures contracts, thus creating a short position. To simplify the example we may assume that the futures contracts mature immediately before the end of the first accounting year. We may further assume that the change in the market value of the futures contracts completely offsets the change in the value of the investment.

Table 1.3: Hedging strategy of firm B

		Actual change in LIBOR after one year		
For year two (in £m)		no change	1% increase	1% decrease
Asset:	Market value start of year	100.0	99.1	100.9
	Cash flow end of year	108.0	108.0	108.0
Liability:	Market value start of year	(50.0)	(50.0)	(50.0)
	Cash flow end of year	(53.5)	(54.0)	(53.0)
Treasury futures:	Market value start of year	0.0	0.9	(0.9)
	Cash flow end of year*	0.0	1.0	(1.0)
Total exposure:	Market value start of year	0.0	0.0	0.0
	Cash flow end of year	0.0	0.5	(0.5)

*Invested at the rate of the asset

As reported in table 1.3, firm B may be able to fully offset its exposure to market value risk by using the futures contracts. It turns out that this hedging strategy creates cash flow risk, which incidentally does reverse but not reduce the total expected cash flow exposure of the firm when compared to the case without hedging (see table 1.1).

Now, how can and should these firms appropriately report their respective hedging strategies? Using a traditional transactions-based reporting model *without* hedge accounting, the exposure to changes in market value would not be reflected. The different cash flows associated with interest rate changes would be reflected in the profit and loss statement for each respective year. Therefore, the traditional accounting system would portray cash flow hedges as effective and market value hedges as ineffective. The two types of hedge accounting - deferral hedge accounting and mark to market hedge accounting - would also portray the results of the different hedging strategies differently. To see this, let us assume

that LIBOR increases by 1%. For firm A, the two types of hedge accounting might be contrasted with the traditional accounting without hedge accounting as presented in table 1.4.

Table 1.4: Accounting for firm A

At the end of year 1 LIBOR increases from 6 to 7%	**No hedge accounting**	**Deferral hedge accounting**	**Mark-to-market hedge accounting**
Closing balance sheet year 1:			
Asset	100.0	100.0	99.1
Cash	4.5	4.5	4.5
Liability	(50.0)	(50.0)	(50.0)
Swap	-	-	0.5
Net assets	54.5	54.5	54.1
Profit and loss for year 1:			
Net interest received	4.5	4.5	4.5
Loss on asset	-	-	(0.9)
Gain on swap	-	-	0.5
Net profit	4.5	4.5	4.1
Profit and loss for year 2:			
Net interest received	4.0	4.0	4.0
Gain on asset	-	-	0.9
Gain on swap	0.5	0.5	-
Net profit	4.5	4.5	4.9

To evaluate the accounting method, we may construct the profit in year one as a benchmark for profit in year two, assuming that there is a preference for less to more variability in earnings.[20] Assuming all instruments were kept until maturity, for firm A there would be no difference in reported profits under traditional accounting without hedging and deferral hedge accounting and the hedge would be seen as effective. With mark to market hedge accounting, the market value of the swap would be recognized and shown on the balance sheet at the beginning of year two. Depending on the degree to which full fair value measurement for financial instruments was required, the asset would be shown at fair value as well. As this would result in recognizing the gain on the swap in year one rather than in year two, it would be incongruent with the adopted hedging strategy of firm A and may thus be inappropriate. On the other hand, as the gain on holding the swap would not be reported

[20] This seems to be a convenient assumption for this illustrative discussion. However, there have been early suggestions that this is how firms establish notions of appropriateness of the accounting treatment of hedges (Goodfellow 1988).

under historical cost accounting, the net profit for period one could be boosted by selling the swap. In the regulatory debate, this practice became referred to as 'cherry picking'.

Table 1.5: Accounting for firm B

At the end of year 1 LIBOR increases from 6 to 7%	No hedge accounting	Deferral hedge accounting	Mark-to-market hedge accounting
Closing balance sheet year 1:			
Asset	100.0	100.0	99.1
Cash	5.4	5.4	5.4
Liability	(50.0)	(50.0)	(50.0)
Deferred gain on future	-	(0.9)	-
Net assets	55.4	54.5	54.5
Profit and loss for year 1:			
Net interest received	4.5	4.5	4.5
Loss on asset	-	-	(0.9)
Gain on futures	0.9	-	0.9
Net profit	5.4	4.5	4.5
Profit and loss for year 2:			
Net interest received*	4.1	4.1	4.1
Gain on asset	-	-	0.9
Amortized gain on futures	-	0.9	-
Net profit	4.1	5.0	5.0

*Cash from future invested at rate of asset

In the case of firm B profits under mark to market hedge accounting and deferral hedge accounting would be the same, largely because of the assumed high hedging effectiveness. Of course, in cases of lower hedging effectiveness, the results might be different between the two accounting methods. As can be seen from table 1.5, mark to market hedge accounting appears to be more congruent with the strategy adopted by firm B, suggesting that mark to market hedge accounting might be considered as the more appropriate accounting technique.

This example illustrates how accounting may render certain financial risks and exposures to financial risks visible while hiding others. Furthermore, it illustrates that adopted notions of risk and resulting hedging strategies can be congruent with specific ways to account for them. It suggests that the visibility rendered by different accounting practices may come to inform different notions of appropriateness of accounting solutions. In this way, notions of appropriateness of accounting problems and solutions may be thought of as being constructed by accounting and reproduced as meaningful. We will return to this point in the

following chapters, in particular in chapters four and five.

Given the ambiguity about notions of financial risks and their appropriate representation in accounting, what was the solution that emerged in the IASC project on financial instruments? In line with the guidance on hedging developed in the FASB's SFAS 80, the first Exposure Draft on financial instruments by the IASC (E40), published in 1991, suggested a mixed approach to hedging.[21] However, the IASC exposure document proposed that hedging instruments should be accounted for based on the way the hedging relationship was classified by management. If, for example, instruments hedged off-balance sheet exposures, such as committed future transactions or exposures from investing and financing instruments, deferral hedge accounting was to be applied. If instruments hedged trading instruments that were carried at market value, mark-to-market hedge accounting was proposed. In the subsequent debate, the major criticism of hedge accounting in E40 was that the distinction between trading and non-trading was depending too much on intent and on the idiosyncratic construction of financial risk by management.

The IASC's second attempt to develop an Exposure Draft on financial instruments (E48) also relied on a mixed model and received similar criticism. Furthermore, E48 applied a test of fair value changes for qualifying hedges and disallowed instruments that were held to maturity to qualify as hedges. It disallowed for example swaps that converted a floating rate debt to a fixed rate debt to be considered as hedges, which would have been in conformity with the hedging strategy that we attributed to firm A in the example above. Many constituents regarded excluding certain hedges hedging cash flow risks as too restrictive. On the other hand, E48 allowed hedging of future transactions, even if they were uncommitted but exposed the entity to interest rate, currency or market price risk as long as they were 'highly probable'. Some commentators saw this as too permissive, as it was seen to give a free hand to management for classifying and reclassifying hedging relationships. In critically commenting on E48, the FASB came to outline what later became established as an international benchmark for hedge accounting. It also became the core of the guidance

[21] For an overview of all major project documents refer to appendix A3. For more technical details on the recognition and measurement guidance in the IASC proposals refer to appendix A4.

included in the FASB's own standard on hedging that was published in 1998 (SFAS 133). It was further taken up in the IASC's guidance on financial instruments, which was issued in late 1998 (IAS 39):

> ... many constituents of the FASB have indicated that they hedge the risk of variability, rather than of loss, and they hedge cash flow risk, in addition to or instead of market value risk. Since then, the FASB and staff have been attempting to find a hedge accounting solution that would permit special accounting for risks associated with both market values and cash flows. ... it appears that most, if not all, hedges of anticipated transactions essentially fix a future price or a future cash flow. ... The effectiveness test (for hedges of existing assets, liabilities, and firm commitments, as well as for forecasted future transactions) currently being considered by the Board for conventional hedge accounting is one that would limit the deferral of gains and losses to the extent that the cumulative change in fair value of the hedging instrument counterbalances the cumulative unrecognized change in the fair value of the hedged item.[22]

With hindsight, the principles underlying these comments were strikingly simple. The first step was to introduce a requirement that instruments had to be reliably measurable in order to qualify as a hedge or as an instrument to be hedged. Since both, the hedge and the hedged item, had to be reliably measurable the hedging *and* the hedged position could be presented on the balance sheet at their fair value. The result was to be similar to mark to market hedge accounting for the firm B in the example above. Offsetting value changes were to be reported in income. Net gains and losses could only occur to the extent that the hedging relationship was ineffective. The remaining issue was what to do with hedges of items that were not recognized yet, that is, future uncommitted transactions? The suggestion was to defer all gains and losses on hedges of anticipated transactions in other comprehensive income or equity.[23]

However, this seemingly straightforward way of *solving* the accounting for hedges was the result of an arduous process of rethinking fundamental concepts of accounting. Capturing hedging in terms of accounting seemed to be difficult as long as guidance attempted to rely on notions of financial risks, which did not seem to have straightforward accounting correlates. Early proposals tried to base recognition of financial instruments on a distinction

[22] Letter by FASB to IASC, 26 July 1994.

[23] IAS 39, in close reference to SFAS 133, suggested recognizing the ineffective part of the hedge immediately in income and deferral of the effective part of the hedge in equity. Refer to appendix A4.

between different types of financial risks, such as credit risk, foreign exchange risk, interest rate risk, liquidity risk, market risk, etc. This involved translating different classes of risks into accounting terms. Although referring to types of instruments, it effectively relied on discretionary assessment of risk components by management. Only after the emergence of notions of cash flow risk and fair value risk did the accounting guidance for mark-to-market hedging seem to find a broader resonance in the regulatory debate.

However, the debate remained polarized by different notions of appropriateness of risk representation even after synthesizing financial risks in terms of fair value and future cash flows. These notions corresponded to the archetypical models of firm A and B in the above example. For instance, bankers seemed to be more concerned about cash flow hedging, similarly to firm A. They argued that the fair value or market value approach to hedge accounting was 'contrary to the risk management and reporting philosophies of most banks'.[24] The notions of appropriateness advanced by banks thus appeared to relate more to the way banks had traditionally constructed their financial risk in financial reporting, as will be discussed in more detail in the following chapters.

The way financial risks were constructed established contested benchmarks for what hedge accounting can and should be and what was seen as speculation, even at the end of the 1990s. As this introductory discussion of hedge accounting suggests, the regulatory debate on accounting for financial instruments remained subtly immersed with fundamental understandings about the role and meaning of accounting. The debate about financial instruments seemed to involve opposing ideas about risk and conceptualizing of financial risk in terms of accounting. As will be discussed in this thesis, these understandings came to inform notions of problems. 'Solving' them seemed to rely on establishing shared notions of appropriateness that would draw on support from conceptual ideas, credible experts and strong organizations. In particular 'solving' accounting for financial instruments seemed to rely on constructs of risk that were seen to be independent from management intent and supported by a strong conceptual foundation. Furthermore, solutions also seemed to depend

[24] As argued in comment letter to Canadian Institute of Chartered Accountants (CICA) Draft Statement of Principles by Canadian Bankers' Association, 20 July 1990.

on shared notions of appropriateness within an increasingly global network of standard setting experts.

International standard setting: soft or hard?

Accounting for financial instruments became the first accounting issue to assemble a genuinely global network of experts and organizations with aims of developing comprehensive standards for all major jurisdictions. This collaboration came to challenge not only the way the IASC had been working traditionally but also the traditional national approaches to standard setting and due process. In contrast, international harmonization of accounting guidance until the late 1980s seemed to be more akin to a mimetic diffusion process.[25] For many accounting issues, principles and practices that had evolved in one jurisdiction were taken up gradually in other jurisdictions. Principles and practices seemed to travel particularly after codification and standardization in one jurisdiction, often the U.S, as was the case for hedge accounting. Hedge accounting was first codified and standardized in the U.S. context. Other jurisdictions, like the U.K. that did not have codified guidance on hedge accounting were subsequently seen to refer for authoritative guidance to U.S. standards (Davies et al. 1997; Adedeji and Baker 1999). This process appeared to be encouraged by large accounting firms for other countries as well (KPMG 1995). In an increasing number of cases, however, international technical collaboration between national bodies became involved in standard setting. For example, with respect to the major accounting issues that emerged in the 1970s such as foreign exchange translations and inflation accounting, North American and U.K. standard setters were seen to collaborate informally. This collaboration was later extended to the Group of Four (G4) (Street and Shaughnessy 1998).

In contrast to the more contingent diffusion process of harmonization by mimesis, the IASC had emerged early as a formal attempt to foster international harmonization in accounting

[25] See DiMaggio and Powell (1991b). Most of the research on the diffusion of accounting techniques seems to relate to management accounting. There seem to be only few commentators that casually mention the diffusion of financial accounting concepts across jurisdictions, e.g., Bloomer (1996; 1999), Davies et al. (1997).

practice. A first foundation had been laid with the formation of the Accountants' International Study group in 1966. In 1973, the IASC was established in London by professional accountancy bodies in nine countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the U.K. and the U.S. The foundation of IASC came to be seen as shaped by the initiative of Sir Henry Benson (Bocqueraz and Walton 1999). The constitutional objectives of the IASC were to formulate and publish accounting standards and to promote their worldwide acceptance and observance. It also aimed at working more generally for the improvement and harmonization of regulation, accounting standards and procedures relating to the presentation of financial statements.[26]

After 25 years of standard setting, the IASC's membership had came to include all professional accountancy bodies that were members of the International Federation of Accountants (IFAC).[27] Apart from professional accountancy bodies, other organizations increasingly became involved in the work of IASC, some of which gained observer status on the Board, for example the European Commission and FASB. By 1999, IASC had completed a core set of standards that were to be assessed by the International Organization of Securities Commissions (IOSCO) for global acceptance (Cairns 1999). In developing these core standards IASC was seen to move from a set of *soft* standards allowing a wide range of options to *harder* standards that were intended to be comparable to U.S. guidance (Bloomer 1996; 1999; Zeff 1998).

In the course of the 1980s and early 1990s, despite attempts to develop hard international accounting guidance and to promote harmonization, some market regulators - in particular the SEC - remained reluctant to support IASC standards. However, during the late 1990s standard setters and market regulators came to face increasing political pressures to develop

[26] Refer to constitution of the IASC, par. 2 (available online at www.iasc.org.uk).

[27] As of September 1999, the membership included 134 member organisations, five associate members, and four affiliate members. Those organisations together represented over 2m accountants in 104 countries. Associate members included organisation such as the Association of Accounting Technicians and the Association of Professional Accountants and Auditors of the Republic of Moldova. Affiliate members included the Accounting and Auditing Organization for Islamic Financial Institutions, the Federation Internationale des Experts Comptables Francophones, the Information Systems Audit and Control Association and the Institute of Internal Auditors (Source: www.iasc.org.uk).

internationally harmonized guidance. For example, following the Asian crisis in 1998, politicians at G7 meetings and international organization like the World Bank came to exert public pressure on Big Five global audit firms to improve audit standards in Asia.[28] In view of such mounting pressures, international reporting became 'the hottest accounting topic around the world' and, even at the FASB, harmonization of accounting standards moved high up on the agenda.[29]

The increasing demands for international standards during the 1990s came to let observers wonder whether and, if so, how a genuinely international standard setting regime may emerge (Cairns 1997; Flower 1997; Zeff 1998). There seemed to be considerable debate about how these standards were going to be produced. The disagreement about the future shape of harmonization became even more obvious in the debate following the recommendations of the Strategy Working Party. This disagreement and the resulting uncertainty about the IASC's future notwithstanding, the project on financial instruments became like a test case for international collaboration as well as the IASC's future. It became the first project for developing an international standard with the involvement of the major bodies in the field of accounting regulation. It was seen as crucial that the emerging guidance would compare favorably with other guidance in terms of being more than just another 'soft' IASC standard with plenty of scope for management discretion.

The concern to develop 'hard' accounting guidance allowing little discretion put considerable constraints on the IASC project. It seemed to require a thorough conceptual foundation for the project right from its start. By the mid 1990s, as the IASC came to struggle with its project, some national standard setters closer involved in the project eventually made it clear that the conceptual shifts involved in accounting for financial instruments required a concerted international effort. Eventually, the IASC came to develop IAS 39, which still came to be seen as being rather soft, while a more resolute approach to accounting for financial instruments was also being aimed for. In this way, the work on the

[28] On 19 October 1998, the FT reported that the World Bank had asked leading accounting firms to stop putting their names to accounts published in the Asian economies unless these are drawn up using high-quality international financial reporting standards.
[29] Interview Z, December 1998.

'interim' standard IAS 39 came to increase the momentum to establish the Joint Working Group (JWG) on financial instruments, in November 1997, as a platform to develop a 'conceptually sound' accounting system for financial instruments. The way in which the financial instruments project came to depend on and foster an international network of experts, standard setters and ideas to establish the hardness of the accounting guidance will be elaborated in this thesis.

Structure of the thesis

The focus of this thesis is the financial instruments project of the IASC between 1988 and 1998. The research does *not* set out to answer in a normative sense the question of how financial risk should be represented. Rather, it tries to address empirically the following set of questions: what *notions of appropriateness* were invoked in the regulatory debate and who and what supported them? How did these notions of appropriateness change over time? What resistance did these notions find in the regulatory debate? Analyzing notions of appropriateness relies on observing contributions to the regulatory debate by participants in the process of policymaking, in particular looking at arguments employed as justifications for specific accounting treatments. It relies on analyzing these contributions over time to appreciate emergence, shifts and conflicts in the underlying notions of appropriateness. The evidence referred to in this thesis comprises of written contributions by participants to the policy debate, interviews and archival project documents. Appendix A2 contains a list of those 33 interviews that were recorded and transcribed. The partners in these interviews were experts directly or indirectly involved in the IASC's financial instruments project. They were involved in the project as standard setters, close observers, or representatives of major constituents. The interviews were semi-structured and lasted up to two hours. In most cases, they started with specific questions in reference to written contributions or submissions that interviewees had made to a particular project document. The interviews usually centered on those particular issues that the specific interviewee considered important in the debate on financial instruments.

The material in this thesis is organized as follows. Chapter two reviews the extant literature

and previous research on accounting regulation. In line with the analytical focus of this thesis, the review chapter looks at the role attributed to the conceptual foundation of accounting in the literature on accounting regulation. Based on the review, the chapter discusses the analytical framework adopted in this thesis and aspects of the theoretical understanding of accounting regulation that emerges from the case of financial instruments. The theoretical building blocks introduced in chapter two are further developed in the body of the thesis and summarized in the concluding chapter six.

Chapter three considers the early phase of the IASC's project, which was formed in 1988. It looks at the way in which the regulatory initiative by the IASC came to co-evolve with regulatory concerns at the 'margins of accounting' and in close reference to what the U.S. Financial Accounting Standards Board was doing. It shows how new classifications built on conceptual premises, which transcended traditional accounting knowledge, shifted the notions of appropriate *problems* to be addressed by accounting standard setters. As argued in chapter three, off-balance sheet transactions were reclaimed as accounting objects by subsuming them under the notion of 'financial instruments'. This allowed extending the knowledge base of accounting representations into new territory by addressing the representation of financial risk in terms of accounting. As the chapter argues, during the early phase the IASC did claim international leadership in this respect, supported by a then still fragile network of organizations, experts and concepts.

Chapter four illustrates the changing notions of appropriateness of accounting *solutions* for financial instruments together with emerging techniques for representing financial risks in terms of accounting. As the chapter shows, emerging guidance on recognition and measurement of financial instruments was primarily concerned with representing the impact of future events. The parallel shifts in guidance for recognition and measurement limited the scope for management discretion in recognizing financial instruments, but increased the scope for professional judgment for measuring them. Fair value came to be seen as a viable solution to deal with representing financial risk related to contracts that establish financial instruments. As an ideal-type representation of the changing financial 'reality', it came to provide meaning to accounting and direction to regulatory initiatives. However, the use of

fair value became contested as it challenged banks' claims to representing and managing financial risks.

How *conflicting notions of appropriateness* affected the regulatory debate on financial instruments is the topic of chapter five. The chapter looks closer at one particular aspect of the regulatory debate: the accounting for long-term debt under a fair or current-value measurement system. The analysis in this chapter considers the debate following a discussion paper published by the U.K. standard setter in July 1996, which predated and influenced an important IASC Discussion Paper published in 1997. The chapter examines in more detail the premises underlying the arguments raised in favor and against the ASB proposal to revalue long-term debt in terms of the differing underlying notion of appropriateness to reflect financial risk. The analysis shows that the arguments clustered around two sets of premises, which can be contrasted as referring to different models of firms. A model of the firm supporting traditional notions of appropriateness was being challenged by another model to reflect more of 'what the world does to the firm'.

The concluding chapter six summarizes the findings presented in the three core chapters. It also reflects on the structure of the international debate on financial instruments and discusses the elements of the increasingly closely-knit global network, in which the IASC and major national standard setters featured together with other organizations, experts and ideas. The concluding chapter also presents and discusses theoretical and policy implications that can be drawn from the case.

There are five appendices, which provide supporting material for the argument developed in this thesis. Appendices A1 and A2 contain respectively abbreviations and a list of those interviews, which were recorded and transcribed. Appendix A3 contains a detailed list of major events and documents related to the project on financial instruments. It goes back to 1973, when both the IASC and FASB were set up and highlights the most important documents and events that contributed to the regulatory debate. The end of 1998 is the cut-off for the research, although some later publications are referenced in the thesis. The detailed references for each of the documents are contained in the bibliography. Appendix

A4 contains a rather technical comparison of the major IASC documents with respect to guidance on recognition and measurement, which is related more closely to chapter four in the main body of the thesis. Appendix A5 contains some statistics and further comments regarding the global structure of the regulatory debate on financial instruments.

CHAPTER TWO:

Models of accounting regulation

Models of accounting regulation

Abstract

In the extant literature, different epistemological assumptions have resulted in very different conceptualizations of accounting regulation. This chapter analyzes this literature into four types of models: the normative model of the ideal profession; the model of political lobbying; the model of professional jurisdictions and the model of the regulatory arena. These models are contrasted with respect to different analytical dimensions: the main explanatory variables as well as the roles assigned to standardization and to accounting theory. After discussing the literature in terms of these four models, this chapter draws some conceptual and methodological conclusions for the research presented in this thesis.

Introduction

Since the 1970s, accounting regulation has become theorized in ways that challenged traditional understandings of the purely technical nature of accounting (Hopwood and Miller 1994). This more recent literature came to highlight two dimensions of accounting regulation: the relationship between abstract accounting knowledge and practice as well as the social context of accounting. Incorporating these two dimensions into models of accounting regulation allowed establishing new and different understandings of the regulatory process. It also allowed integrating into accounting research concepts from economics, sociology, organization theory, political science and other intellectual traditions.

In contrast, most of the extant research on accounting regulation has focused on accounting regulation within a regime of private or quasi-private standard setting serving developed capital markets. While this chapter does not consider the literature dealing with specific national traits of accounting and issues of taxation and law, it attempts a review of the fragmented literature on accounting regulation with a view towards comparing and discussing epistemological assumptions underlying different conceptualizations. Looking at the implicit and explicit assumptions, the literature will be analyzed into four models. These

models result from confronting the literature with three questions as summarized in table 2.1 below: (1) As the literature review shows, different research traditions tend to highlight different explanatory nexuses while neglecting others. The first question therefore is: What are primary sources of demand for accounting regulation in the literature, or what is the primary explanatory variable? (2) Depending on the presumed explanatory variables, accounting standards are seen to serve different roles in the different literatures. The second question therefore is: What are the roles accounting standards are seen to play in serving these demands, or how do accounting standards impact on outcomes? (3) Like accounting standards, accounting theory is seen to play different roles in the different literatures and to gain different levels of importance depending on the type of model. The third question therefore is: What is the specific role of accounting theory?

Table 2.1: Contrasting models of accounting regulation

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
XYZ	(1) What is the primary explanatory variable adopted in the model?	(2) What are the roles accounting standards are seen to play in serving these demands?	(3) What is the specific role accounting theory is seen to play in the model?

Applying this heuristic schema, this chapter contrasts four theoretical perspectives with different epistemological foundations. These are referred to as follows: the normative model of the ideal profession; the model of political lobbying; the model of professional jurisdictions and the model of the regulatory arena. Each of these perspectives will be discussed in reference to the heuristic schema outlined in table 2.1. The discussion will help to supply conceptual building blocks for the research presented here and to provide a justification for the choice of the model adopted in this thesis.

Normative model of the ideal profession

Most contributions to regulatory debates in accounting by academics and practitioners originating between the 1920s and the 1970s can be seen to non-problematically justify accounting in reference to a functional demand of accounting. A modernist, teleological idea of regulatory progress may be seen as the foundation of much of this early literature.

Accounting standards were seen as assisting the accounting profession to provide ever better accounting. In particular with the rise of accounting standards in the United States did accounting theory come to muster as an important source for justifications for specific accounting guidance (Galbraith 1961; Zeff 1972; Moonitz 1974; Merino and Neimark 1982; Bealing et al. 1996).

A widely shared optimism was seen to prevail in early accounting research that axiomatic principles of accounting would allow supporting and facilitating the development of accounting guidance. In particular during the 1960s, the golden age of *a priori* research of accounting, abstract accounting theories did emerge with the aim of establishing fundamental axioms (Paton and Littleton 1940; Moonitz 1961; Mattessich 1964; Chambers 1966), which were later bereft of their importance (Mattessich 1980). Arguments for a deductive approach to accounting regulation relied on the idea that accounting theory would enlighten professional practice. The relevance of theory was seen to derive from its ability to frame the functional demands on accounting and to inform practice to better fulfill these demands. Functional demands on accounting were seen to provide an unbiased *telos* of accounting, thus helping to close the conceived gap between aspirations and the reality of professional practice (Hopwood 1983).

The conceptual framework project in the U.S. became the epitome of a regulatory concern with general principles of accounting. With the help of its framework, the FASB attempted to develop a firm theoretical underpinning for accounting regulation. The framework came to be built upon twelve objectives and seven qualitative characteristics of financial accounting that were established in the so-called 'Trueblood Report', a documentation of findings of an AICPA study group published in October 1973. To derive general principles, the FASB was seen to apply a means-end schema (Archer 1993). It assumed a hierarchical and teleological relationship between functional objectives and means of accounting:

> Objectives should identify the goals and purposes of accounting. Standards should follow logically from objectives, and should provide guidelines for the formation of accounting practices compatible with the desired goals.[30]

[30] Appendix A of AICPA (1973).

Earlier and somewhat less systematic attempts to formulate a conceptual framework of accounting dated back as far as the 1920s. Landmarks include an American Accounting Association (AAA) paper on principles underlying financial statements in 1936, the Paton and Littleton (1940) attempt to provide a 'coherent, coordinated, consistent body of doctrine' and Statement 4 of the APB. Eventually, the conceptual framework by the FASB came to comprise of five concept statements published between 1978 and 2000.[31] These concept statements were seen to provide a coherent system of interrelated objectives and fundamental elements that would lead to consistent standards by prescribing the nature, function, and limits of financial accounting and reporting.

The axiomatic research leading to the conceptual framework project had attempted to establish deductive and inductive patterns of arguments linking theory and its application in professional practice. Chambers (1955) following Paton and Littleton (1940) had set the stage for a thorough axiomatic foundation of accounting by pointing out that earlier normative theories provided systems of rules rather than theories. He called for a set of more fundamental propositions and suggested a number of fundamental premises of accounting. A similarly comprehensive attempt to develop axioms of accounting became Mattessich's book (1964) on accounting and analytical methods. Mattesich's work provides an interesting example for the academic endeavor that went into developing an axiomatic foundation of accounting and that ventured beyond accounting principles relying on historically derived principles. At the same time, his work provides an example for the conceptual limits to formalizing accounting and deductively guiding accounting regulation.[32]

---

[31] There are actually seven FASB Concept Statements as follows: No. 1: Objectives of Financial Reporting by Business Enterprises (published November 1978); No. 2: Qualitative Characteristics of Accounting Information (published in May 1980); No. 3: Elements of Financial Statements of Business Enterprises (published December 1980); No. 4: Objectives of Financial Reporting by Nonbusiness Organizations (published December 1980); No. 5: Recognition and Measurement in Financial Statements of Business Enterprises (published December 1984); No. 6: Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 - incorporating an amendment of FASB Concepts Statement No. 2) (published December 1985). Concept Statement No. 7 was added in February 2000: Using Cash Flow Information and Present Value in Accounting Measurements.

[32] There are some epistemological reasons why the axiomatic project had to fail, which cannot be discussed in more detail here. However, Peirce's (1957) 'pragmatism and pragmaticism' can be understood to show that induction and deduction fail as syllogisms to explain the logic of a pragmatic practice like accounting.

Mattessich saw accounting as a discipline concerned with the quantitative description and projection of income circulation and of wealth aggregates. He envisioned a set of basic assumptions about, among others, monetary values, time, economic objects, agents, entities, and transactions. He tried to abstract these assumptions or principles and thus to provide the axiomatic foundations for any functional accounting system. After publishing his first attempt to postulate axioms of accounting (Mattessich 1957), he was invited to Berkeley. In Berkeley Mattessich came to work with Moonitz, who was later appointed to become Director of Accounting Research at the AICPA and published his own basic postulates of accounting as an AICPA research study (Moonitz 1961). While arguably less rigorous than Mattessich's attempt, Moonitz's study became influential for the conceptual framework project, which was conceived ten years later with Moonitz becoming a member of FASB.

The normative accounting research tradition focused primarily on the relationship between theory and practice. It considered, on the one hand, the functional demands of accounting practice and, on the other hand, the logic of accounting theory (Littleton 1948; Ross 1967). The relationship between these two poles became discussed as an issue of induction and deduction. Different leanings towards induction or deduction were reflected in differences between, for example, Mattessich (1964) and Chambers (1966). Both agreed in principle that fundamental accounting concepts needed to be induced from an observation of accounting practice and that accounting concepts should help to deduce specific accounting guidance. Mattessich, however, came to believe that basic assumptions should be gained inductively by examining various micro- and macro-accounting systems, which he contrasted with Chambers' (1966) attempts to develop a general theory of accounting:

> Whereas I tried to infer inductively the basic assumptions by studying various extant micro- and macro-accounting systems ..., Chambers started from a preconceived, and to my mind, dogmatic objective. For him the major task of accounting is the representation of *market prices* in financial reports ... whereas for me the objective of accounting was and still is the *valuation* of assets, liabilities, owner's equities, flow of services, etc. ...[33]

The idea was that by separating a general theory from its specific interpretations, it would

[33] Mattessich (1980), p. 30, original emphasis.

become possible to construct, within a single theory, various interpretations by deducing specific guidance from the same set of general principles depending on the specific empirical objectives. Other authors advancing a similar inductive argument included Spiller (1964), who characterized the objectives of accounting theory as classifying business transactions and events by abstracting their underlying characteristics. Such abstract characteristics were seen to provide the basis for specific deductions by the accounting practitioner, who was seen as an artist juggling to apply these general principles.

The almost exclusive focus on the relationship between accounting theory and practice in this literature meant that less consideration was given to the social context in which accounting was taking place. Even in the early 1970s, when the literature came to embrace an *information* perspective (AICPA 1973; Carsberg et al. 1973; ICAEW 1975; Beaver 1989) this new analytical tradition did not come to specifically address third party intervention. The information perspective shifted the functional need that accounting was seen to satisfy from *income* measurement to providing *information*. While construing the functional purpose of accounting from the idea of an information system, epistemologically, it seems fair to argue that the 'accounting revolution' of the early 1970s remained concerned with the deductive construction of guidance from general principles.

We may synthesize the explanatory structure of the normative model of the ideal profession according to table 2.2. The model assumes a functional role of accounting. Accounting standards act as rules for accounting practice and their application is seen to be rather unproblematic. At the same time, there is a strong emphasis on the role of accounting theory to provide deductive guidance by drawing on fundamental principles or axioms.

Table 2.2: Normative model of the ideal profession

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
Normative model of the ideal profession	Functional role of accounting	Rules for accounting practice	Deductive theory drawing on fundamental axioms

This normative model of accounting regulation seems to assume a realist and rather *passive* role of accounting theory. Firms' financial risks, performance and financial position appear

to exist independent of their representation and independent of the accounting for them. Obtaining knowledge about the best way to present financial performance and position appears like discovering existing laws of nature, which 'are there' to be discovered. Once knowledge about these laws is obtained, they may be used to guide accounting regulation towards improving standards for financial reporting. As the model presumes a clear functional purpose of accounting, there has to exist a first-best set of premises of accounting reflecting this functional demand. Ultimately, this means that there can be only *one* accounting theory that is truly reflective of the functional reality of accounting.

Apart from the various conceptual frameworks that are justified along the lines of this model, any regulatory debate generates an ongoing stream of normative accounting literature. By applying inductive and deductive arguments, this literature can be seen to guide practice, either by means of deduction from common sense meaning given to accounting or in reference to a codified conceptual framework. Most reasoning and justifications provided by standard setters in support of specific accounting guidance can be seen to apply some form of deductive syllogism linking conclusions to general principles. Meanwhile, the recognition of the social context of accounting regulation and the discovery of 'economic consequences' (Zeff 1978) contributed to a new academic literature that came to position itself in opposition to this normative model of the ideal profession.

Model of political lobbying

Before the 1970s, the accounting model employed by the AICPA and the APB simply referred to accounting principles to denote the structuring principles of accounting regulation. Standard setters, constituents and critics were seen to frame support for and objections to accounting guidance in terms of such principles. However, as Zeff (1978) pointed out, since the 1940s, third parties were seen to intervene in the standard-setting process, appealing to criteria that transcended the traditional notions of accounting measurement and fair presentation by highlighting the economic consequences of accounting pronouncements. The growing awareness that lobbyists influenced standard setting came to discredit the role of academics and normative accounting theory in

accounting regulation (Zeff 1974). Furthermore, rather than revealing the ends of accounting, accounting theory came to be seen as a means in a fundamentally political process to influence accounting regulation. Watts and Zimmerman (1979) eventually argued that theory based justifications might first of all provide excuses in advancing the interests of particular constituents. This proposition became rather unsettling for accounting researchers as well as for the professional community that became seen to rely on a discredited conceptual basis. The Watts and Zimmerman paper gained its particular theoretical and political significance by challenging the assumptions about the theory-practice nexus underlying FASB's conceptual framework project.

In contrast to the axiomatic research project, the positive model of political lobbying suggested a less ambitious understanding of the role of accounting theory. An important catalyst for this new understanding was the introduction of ideas from economics into research on accounting regulation. The notion that policy making and thus standard setting by private groups was rarely ever in the public interest had become by then the basis of a well-established political science literature (Downs 1957; Olson 1971; Stigler 1971; Posner 1974). Without implying bad motives or exclusionary practices on part of the regulators, this literature saw those interests that were best organized and most entrenched as the most likely to influence policies (Kariel 1961). As regulators were unlikely to hear from diffuse interests, the logic of collective action (Olson 1971) suggested that diffuse interests were likely to be underrepresented, whatever the forum. While diffuse interests could be temporarily galvanized by catastrophic events, in the longer run concentrated interests of the regulated were likely to prevail. Downs' (1957) theory of democracy and Stigler's (1971) theory of economic regulation became influential for shaping what later came to be known as positive accounting theory. Stigler argued, similarly to Olson, that the structure of political decision making was likely to lead to the consideration of strong preferences rather than weak preferences on any particular policy issue.

Applying these intellectual concepts to accounting regulation, Watts and Zimmerman (1979) aimed at contributing to a meta-theory of accounting theory production. Rather than considering accounting theories as expressions of functional demands or a universal logic,

they argued that accounting theories were supplied on demand like other marketable goods. The Watts and Zimmerman paper thus not only highlighted the ambiguous role of applied accounting theory but even more so the social context of accounting regulation. It did so by contrasting two regimes, one with and the other without government regulation. While accounting theory in the unregulated regime was seen to serve pedagogic and information demands, in a regulated economy the role of theory for justification was seen to dominate other roles. Accounting theory provided excuses to justify positions by groups with vested interests. Based on contentions that a particular accounting treatment was in the public interest, these excuses were seen to support the interests of particular groups, while high costs of investigation inhibited constituents to reject it or to advance an alternative theory. Watts and Zimmerman tried to support their claim that theories merely provided excuses by showing that accounting theories followed rather than led the introduction of particular government regulation. They discussed three cases: the laws regulating railroads, the income tax laws, and the Securities Acts. The evidence they provided suggested support for their proposition.

The paper by Watts and Zimmerman may be criticized in several ways (Tinker and Puxty 1995). The cases remained rather general and the paper relied heavily on observations by observers of the debate, rather than on primary sources. The examples referred to constellations in which interests were well known and it remains unclear how accounting theory could have strengthened any particular position in these debates. Rather than illustrating *competing* accounting theories, as the notion of 'market for excuses' seems to suggest, all three cases referred to the emergence of a *dominant* theory. There was little support showing that competing theories provided excuses for other interests. Even accepting the Watts and Zimmerman framework, it remains difficult to make sense of the metaphor of theories as *marketable goods*. One way to understand it may be to refer more broadly to *literature* - particularly applied accounting literature - as a proxy for theory. This, however, glosses over differences between applied accounting literature, ranging from the professional press to commissioned reports, and academic literature (including the Watts and Zimmerman contribution). The vast practitioner literature, after all, may not have much

to do with academic theorizing in accounting (Napier and Power 1992). Many writings are, as Watts and Zimmerman observe as well, politically charged statements. They have limited obligation to maintain internal consistency, to consider alternative positions or to cross-reference. In contrast, academic bodies of knowledge or general theories can be seen to pose more rigid demands on internal consistency, criticism within the scientific community, as well as on reference to previous research (Kuhn 1962; Popper 1972).

This criticism notwithstanding, an important contribution of the Watts and Zimmerman paper and the subsequent literature was the argument that accounting regulation is contingent on the dynamics of its social context. Their paper can be seen as paving the way for considering more thoroughly external demands and the social context of accounting regulation. In this spirit, Watts and Zimmerman (1978) advanced their specific positive theory of standard setting, which provided an economics based formal model of lobbying in accounting regulation. As their (1978) paper argued, changes in accounting standards affect management's wealth, most directly through management compensation plans. However, firms are also faced by costs resulting from taxes, from complying with regulations, from costs of political bargaining and from information production, all of which can be seen to impact indirectly on management's wealth. These latter costs might be lower, however, if corporate profits are lower, thus inducing managers to prefer accounting standards that result in lower earnings. Indirect positive effects of lower earnings could even completely offset direct wealth effects. Following this argument, Watts and Zimmerman claimed that, given a proposed accounting standard, the position of management would depend on the size of the firm and whether the proposed standard increases or decreases the firm's reported earnings.

From the perspective of our heuristic framework this model and subsequent studies on lobbying came to focus almost exclusively on the link between external demands and accounting regulation. The independent variable was seen to be a set of identifiable external interests. The political bargaining model is based on an economic perspective construing accounting standards, like other rules or laws, as institutions that alter costs and benefits of various courses of action (Sunder 1997, pp. 161-174). As violations of accounting rules

incur a cost to the offender,[34] the introduction of new rules is seen to change the opportunity set of actors by changing the costs of a particular action, affecting different constituent groups in different ways. Depending on the costs and the stakes involved, this may motivate particular constituencies to lobby against or for changes in accounting standards.

Table 2.3: Model of political lobbying

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
Model of political lobbying	Interests of external constituents for representation of firm performance and value	Affect payoffs	Provide excuses

The model of political lobbying found in Watts and Zimmerman (1979) appears to be less interested in the functional role of accounting and its impact on accounting regulation. It does not specifically consider the conceptual logic of accounting theory for standard setting or the role of accounting in constructing the economic incentives to which the literature alludes. Rather, accounting theory was seen as a reservoir to be used for excuses in the political bargaining process that was seen to determine accounting regulation.

Most of the subsequent research in this tradition looked at lobbying in the context of the FASB (Watts and Zimmerman 1978; Amershi et al. 1982; Kelly 1982; 1985; Francis 1987; Deakin 1989; Kirsch et al. 1990; Mian and Smith 1990; Tandy and Wilburn 1992; Zeff 1997). Other studies analyzed lobbying at the U.S. Governmental Accounting Standards Board (GASB) or other national standard setters (Benston 1982; Hope and Briggs 1982; Hope and Gray 1982; Sutton 1984; 1988; McLeay et al. 2000). More recently, some empirical research looked at lobbying of the IASC (Grinyer and Russell 1992; Kenny and Larson 1993; MacArthur 1996; Larson 1997; Vietze and Chatham 1998). The accounting issues studied within this framework included *inter alia*: foreign currency translations, investment tax credit, general price level changes, depreciation, inventory, oil and gas exploration outlays, research and development, stock-based employee compensation,

[34] Of course, the violation of rules incurs a cost to the offender only, if the rule is enforced (Bromwich and Hopwood 1983; Napier and Noke 1992). The likelihood of being punished for violating the rule thus needs to enter the actors' opportunity set.

pension accounting and consolidation. Apart from looking at lobbying behavior by constituents, researchers have also looked at the behavior of large audit firms, an interest that was triggered by the so-called Metcalf staff report (US-Senate 1977) published in December 1977.

This literature constitutes the largest and analytically most coherent body of research on accounting regulation. However, empirical support for some of the more elaborate hypotheses remained mixed, subject to the empirical specification (Walker and Robinson 1993). The difficulties to obtain consistent results often related to the evidence that was used. Public comment letters to exposure drafts by standard setter had been a convenient empirical source for most lobbying studies. Meanwhile, as Sutton (1984) pointed out, lobbying does not start nor end with comment letters and there is not a single lobbying day. Rather standard setters involve constituents in the drafting process itself, before and after publication of exposure drafts. While lobbying studies that limit themselves to comment letters to exposure drafts have an advantage over other empirical studies, because these letters are publicly available, the repercussions of any other involvement by constituents is not captured by this methodology.

Furthermore, Sutton (1984) questioned whether the analogy between lobbying in accounting regulation and ordinary voting implicit in much of the research could be sustained. The transmission mechanism between interests and regulatory outcomes seems to be more complex than in other policy arenas. Comment letters were just one part of the wider set of methods to influence the standard setting process. As Sutton suggested, in contrast to letters as a method to influence accounting regulation, other direct methods promised to be more effective. Private meetings with the rule-makers could be viewed as the most efficient relative to the time spent on lobbying. Some indirect methods such as appeals to the regulators or Congress might also be more efficient than comment letters and oral testimony at public hearings. Sutton (1984) therefore proposed a hierarchy of methods of lobbying starting with private meetings. Failing a favorable private hearing, lobbyists might gradually resort to what might be seen as less cost-effective measures of lobbying.

One way to deal with the shortcomings of analyzing singular lobbying events was to look at lobbying over time. For example, instead of relying on simple analysis of comment letters, Hope and Gray (1982) analyzed a series of documents published by the U.K. Accounting Standards Committee (ASC) in its attempt to resolve the accounting treatment of expenditure for research and development. Unlike some of the lobbying studies that focused on just one event, this study was seen to result in stronger external validity (Walker and Robinson 1993). Other research in standard setting outside accounting came to argue more generally that simple capture theory may not explain lobbying for all forms of regulation (Cheit 1990; Hutter 1993). As was pointed out, the classic statements of capture theory (Huntington 1952; Bernstein 1955; Stigler 1971) had focused on agencies that regulated prices or terms of market entry. In the case of such agencies, regulation could be explained by reference to the economic stakes involved. In many cases of accounting regulation standards might be seen to affect identifiable stakes, however, in other cases, economic stakes might not be so easily attributable to specific actors or groups of actors.

The link between lobbying and regulatory outcomes seems even more ambiguous when professional concerns or lobbying interaction are taken into consideration. For example, McLeay et al. (2000) found evidence for Germany that was consistent with the view that success in lobbying depended on support obtained from *other* constituent groups. In an earlier study Hussein and Ketz (1991) had tried to establish a model of accounting standard setting as a mixed power system using a similar argument. In reference to Bonoma (1976), a mixed power system with bargaining interaction between at least two parties with equivalent power to bargain to agreement or deadlock was seen to be characteristic of accounting regulation. Hussein and Ketz (1991) held that structural and rational constraints limited the ability of the large accounting firms to dominate the FASB. While conflict among independent public accountants, managers, investors, creditors and others were seen to exist because of mutually irreconcilable goals, none of these political groups was able to control the standard setting process. Hussein and Ketz concluded that standard setting should be seen less as a process dominated by selective interests but as an institution facilitating the bargaining between interested parties. Interested parties were seen to participate voluntarily

as they received benefits in terms of conflict resolution, rationalization of accounting standards and the resolution of uncertainty over financial reports.

Meanwhile, all these variants of the political lobbying model maintained the basic explanatory nexus between interest and regulatory outcome. Compared to the rather static notion of 'true' accounting theory found in the normative model of accounting regulation, models of political bargaining and positive accounting theory acknowledged that theories were employed to support conflicting claims. On the other hand, accounting theory was seen as a strikingly neutral medium. While it provided excuses for interested parties, it was not seen to influence or frame these interests. Considering theories as mere excuses, the positive models of political lobbying tended to omit the role conceptual guidance played, for example, in establishing accounting as a professional practice. While looking at the roles played by large audit firms (Haring 1979; Hussein and Ketz 1980; Brown 1981; Johnson and Messier 1982; Zeff 1986), the research paradigm did not specifically consider the dimension of professional knowledge for accounting regulation.

Model of professional jurisdictions

As Burchell et al. (1980) noted, from the 1970s onwards observers of accounting started reflecting on the assumptions underlying practice, that is, on the theory in practitioners' heads. With a growing understanding that the theory in practitioners' heads was subject to ongoing change, accounting came to be understood as a dynamic knowledge system. Around the same time, accounting came to be seen as a *profession* with the professional institutes providing an interface between the growing agencies of the state and business enterprises. Professional institutes were seen to play an important role as locales for the reproduction of accounting knowledge. As Burchell et al. (1980) argued, the emergence of professional institutes and specialized bodies for the standardization and codification of accounting practice provided new forums in which accounting deliberations and debates could take place. Changes in accounting practice were seen to emanate from these deliberations and debates.

The literature that came to shift the focus on the accounting profession can be seen as part of

a broader concern with professions (Montagna 1974a; Abraham 1978). This literature was concerned with factors that assisted in establishing professional occupations. Authors contributing to this literature asserted that professional tasks needed to be actively claimed and defended from constant threats exerted by competing professions. Professions were viewed as being in conflict with other professions for occupation, whereby conflicts were not only taking place between professions but also groups and segments within the profession itself.

Montagna (1974b) saw professions arising in areas of uncertainty where professional judgment involved choosing from among alternatives with limited knowledge about these alternatives. He saw control over the source of uncertainty to result in control of positions affected by this uncertainty. Control over the body of knowledge that supported judgments therefore was to be maintained jealously by those who had the responsibility and authority to make them. Montagna argued that developing accounting standards or a conceptual accounting framework was similar to the adoption of a scientific method in the area of judgment: it provided legitimacy in the eyes of the public. By imposing rules that often transcended the complexity of practical guidance and interpretation, professional knowledge was seen to maintain professional claims for representation. As Abbott (1988) came to express it later, claims for representation needed to be legitimized by audiences: at the work place, in the judicial arena or in the public arena. Abstraction and codification was seen to assist in convincing these audiences.

Seeing professions as pursuing strategies of exclusively dominating occupational areas by establishing appropriate bodies of knowledge, widened the role of accounting theory compared to the narrow understanding of theory found in the normative as well as in the positive theories. In classifying and making pragmatic judgments, accounting practice was seen to draw on a more or less canonized body of knowledge. Although differing between countries (Power 1997), in the case of financial accounting this abstract knowledge was seen to be maintained by academic professionals, technical partners in accounting firms and standard setters using conceptual frameworks. Professional knowledge had to be able to inform practice, but it also had to be sufficiently opaque for outsiders in order to maintain

the legitimacy of the professional jurisdiction. For example, measuring the value of intangible assets relied on black boxing professional rules (Power 1992). These rules and their application were often complex and probabilistic and needed to remain so to establish and maintain professional jurisdictions. As Bourdieu (1992) expressed it, the logic of practice, which asserts itself in the judgmental act of the professional, needs to maintain a certain vagueness and indeterminacy.

To characterize what distinguishes one occupation from other occupations, Abbott (1988) conceptualized the professional occupation as 'application of knowledge to tasks' - to human problems amenable to expert service. Linking occupational groups with their work area became seen as the central phenomenon of professional life, and the basis for establishing professional jurisdictions. However, jurisdictions, as the professional control of particular tasks, were not defined once and for all, rather jurisdictions at any point in time were seen as the outcome of jurisdictional disputes in the history of professions. For example, in the early days of entrepreneurial risk-taking, the main activity of accountants was seen to be the sorting out of the financial tangles of bankruptcy and liquidation. Later there were shifts of accountants' jurisdiction from bankruptcy to auditing, with a gradual expansion into cost accounting and management services. These shifts were seen to have taken place in competition with lawyers, bankers, management consultants and other professions. They involved reinterpretation of tasks. As Abbott pointed out, the cultural work involved in the professional reinterpretations of tasks were part of larger jurisdictional claims, claims not only to classify and reason about a problem, but also to take action towards it.

Related research in accounting regulation highlighted the mobilization of different bodies of knowledge, in particular in the context of jurisdictional contests (Abbott, 1988, pp. 89-90) between professions at the margins of accounting. For example, in analyzing the case of brand accounting in the U.K. between 1988 and 1990, Power (1992) identified strategies adopted for strengthening and challenging jurisdictional claims of accountants and other emerging expert groups. In close reference to Abbott's model, Pong (1999) described the jurisdictional contest between lawyers and accountants in the context of the off-balance

sheet financing debate in the U.K. between 1985 and 1990. Robson, Willmott, Cooper & Puxty (1994) adopted a similar focus for analyzing the strengthening of jurisdiction claims by the accounting profession. They referred to the ideology of public interest as a means to strengthen the legitimacy of accounting self-regulation in the U.K. during and following the negotiation of the Eighth EU Directive. All these jurisdictional analyses draw on two related concepts: the 'task' and the 'system of professions'.[35]

The consideration of the professional dimension was seen to have repercussions not only for thinking about the role of accounting standards by also for thinking about accounting standard setting. It not only allowed considering demands relating to external constituents but also demands relating to the profession. Placing the model of professional jurisdictions in our heuristic framework, the picture presented in table 2.4 emerges. While the model of the ideal profession did consider professional knowledge, it was primarily to serve the functional demands of accounting presentation. In contrast, the model of the professional jurisdiction highlighted a concern with competing demands to presentation and the external legitimacy of accountant's jurisdictional claim, referred to a 'social capital' by Bourdieu (1992a). The model of professional jurisdictions thus stresses the legitimizing role of standards, particularly at was has been called 'the margins of accounting' (Miller 1998).

Table 2.4: Model of professional jurisdictions

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
Model of professional jurisdictions	Professional claims to task areas (social capital)	Strengthening jurisdictional claims (social capital)	Providing legitimacy

A related academic debate emerged, though somewhat detached from the professional jurisdictions literature, as to whether standard setting had become dominated by professional bodies or firms. In particular the Metcalf report (US-Senate 1977) came to charge that large

[35] Meanwhile, as Abbot pointed out (1988, p. 35), the analytical unit of tasks to which experts can put claims is assumed to pre-exist any jurisdictional contest in some form. The jurisdictional analysis thus requires considering tasks as given problems. It requires bracketing out the way in which problems come to evolve along with jurisdictional claims to solving them. Although Abbot highlights the constructive role of cultural work, the case studies (Abbott 1988, pp. 213-314) focus on the broader system of profession, rather than the emergence of specific task areas.

accounting firms were dominating accounting regulation. In criticizing the conclusions of the Metcalf report, Hussein and Ketz (1980) tried to show that there was disparity between the preferences expressed by large accounting firms and the accounting standards ultimately issued by the FASB. This was seen to shed doubt on the dominance hypothesis. An account of a former staff member of the FASB (Brown 1982) also cast doubt on the dominance hypothesis. Puro (1985), using responses on seven exposure drafts by the FASB, found little supporting evidence that large audit firms colluded with their clients or controlled accounting and auditing, as was suggested by the Metcalf report.[36] Zeff (1986) analyzed professional publications and concluded that partners in large accounting firms, as well as the firms themselves, had come to engage significantly less in advocacy writing since the inception of the FASB.[37]

In particular the conclusions by Hussein and Ketz (1980) were critically discussed by Johnson and Messier (1982) with support from Haring (1979). Haring found an unusually high level of correlation between the preferences expressed by the large accounting firms and the accounting standards ultimately issued by the FASB. And Johnson and Messier came to argue that apparently inconsistent results on big firm power by different studies might be due to a lack of a specified theory of standards setting. In particular, they suggested that Hussein and Ketz had refuted the plausibility of just one possible theory of regulatory dominion - what might be called the ruling elite hypothesis. They did not dismiss, however, other possible theories of regulatory capture, for example a public interest theory. Meanwhile, non-accounting studies in policy making and standard setting in the private sector had come to highlight another aspect, namely that there was a tendency for leading experts to acquire and promote interests different from those of their members (Bernstein 1955; Cheit 1990; Singer 1990; Marsh 1998). This had been referred to as Michels' (1959) iron law of oligarchy, based on a study of political parties in Germany in 1913. Michels had established that positions taken by the oligarchy were often more enlightened than those

[36] Most of these contributions employed an empirical research design that was close to the literature discussed in the previous section and associated with the model of political lobbying.

[37] It may, however, be the case that *firms* engage more in submissions to FASB's due process, as Zeff acknowledges. Zeff's findings thus do not lend themselves to be treated as evidence for less involvement in standard setting by large firms.

favored by the membership. While the model of the professional jurisdiction might suggest that this was due to the cultural work required for the support of professional claims, the model of the regulatory adopted another explanation.

Model of the regulatory arena

In the 1980s a literature emerged that came to focus on the social context of accounting regulation beyond constituent interests and the profession. It came to consider the wider social environment and the role of accounting regulation for the governance of the state (Hopwood and Miller 1994). Most early empirical studies of accounting regulation, starting from the early 1950s to the 1970s, had remained preoccupied with the specificity of the case under consideration and did not approach the context of accounting within a broader research agenda. This new literature came to discuss how accounting could be seen as a set of practices that affected the type of world we live in and the type of social reality we inhabit (Hopwood 1987). It started considering how accounting shapes the choices open to business undertakings and individuals. Accounting became studied by looking at the way in which people managed and organized activities and processes of diverse types, and the way in which people administered the lives of others and themselves.

This perspective suggested to look at accounting not only as a technique that serves functional demands but as a tool to govern and make things governable (Foucault 1979; Miller and Rose 1990; Miller and O'Leary 1993). On the other hand, like the model of the professional jurisdiction, this view pronounced the emergence and role of bodies of knowledge for accounting regulation. It emphasized the constructive role of accounting theory as compared to its rather static role in the normative and positive literature. At the same time, it shifted the focus from the battle line between professions towards the broader policy environment and the state. Rather than considering standards just as part of the accounting profession's legitimization effort, accounting regulation became considered as an enabling device of regulation in the wider social domain. This literature not only considered accounting regulation in reference to accounting knowledge and its legitimating role, but in relation to other bodies of knowledge that were assisting in making things calculable and

governable (Miller and Power 1992; Miller 1998).

A specific model of accounting regulation was introduced by Burchell et al. (1985), who considered accounting regulation as being located in a policy constellation in which the accounting arena was just one among several arenas. Several co-evolving policy arenas were seen to make up one accounting constellation and accounting was seen as affecting as well as being affected by other co-evolving regulatory debates. The social roles that accounting was seen to play in other debates, for instance in the arena of macro-economic management, was seen to influence the accounting discourse and *vice versa*. The accounting discourse was seen to draw on other bodies of knowledge and appropriating techniques. The entire constellation was seen to derive its dynamics from the diverse expectations that financial accounting issues were attracting in relation to regulatory concerns, corporate governance issues, academic careers and so on. By providing a garbage can for expectations, any particular issue was seen to serve as a potential mobilization device in very different social arenas. In the case of inflation accounting, for example, the changing interests of the state were said to have been an important force and a mobilizing issue for accounting regulation. Although part of the debate had no *a priori* relationship with accounting, regulation was seen to result from such external expectations rather than from the functional needs of accounting practice itself.

Unlike the normative model, the model of the regulatory arena did not consider a dominant *telos* of progression of the entire constellation. Neither did the model consider a contingency relationship between interests external to accounting regulation and specific outcomes. Accounting changes were seen to *emerge* within a dynamic constellation of 'issues' leading to shifting expectations internal to the accounting system and external to it. As Burchell et al. (1985) pointed out, within a constellation practices as well as the roles and functions they are seen to serve became subject to change as new issues emerged. Accounting regulation was thus more likely to rise at the interface between the critical media, concerned agencies of the state and a profession concerned with preserving its power of self-regulation and control.

Drawing on Burchell et al. (1985), Robson (1988) discussed accounting regulation in reference to accounting representations of *value*. He argued that representation of value could be seen as one of the central concerns of accounting. However, as he pointed out, the metaphorical *real value* that was to be represented in accounting was never to be observed directly. The notion of value existed only through representations that were premised upon a particular knowledge as to the 'value of something'. Such knowledge was to be called upon, for example, in actuarial assessments. The justification for any particular representation thus depended upon being able to specify and agree upon a control representation that was seen to be consistent with the represented. In the absence of such a benchmark, the search for a 'best' representation remained in principle indeterminate. Robson argued that claims to represent real value prevailed because of the roles that accounting was seen to play. Within the regulatory debate, incumbent professional knowledge provided something like a benchmark about constructing representations of real value. Professional knowledge claims were seen to suggest problems, define areas of investigation and legitimize the practices that had already emerged.

Burchell et al. (1985) had considered an arena as a social field constituted by institutions, bodies of knowledge, economic and administrative processes, systems of norms and measurement and classification techniques. As a 'clarification and elaboration' of this model, Robson (1991) considered accounting as a process of translation (Callon 1980; Latour 1987). As Robson argued, accounting created visibility by translating the quality of things into financial quantities. These translations may become problematized. In reference to Miller and Rose (1990), problematization was seen as the outcome of a process through which discourses and rationales were being translated into procedures and objectives of accounting techniques and calculations. On the one hand, such discourses and rationales were seen to refer to bodies of knowledge and political programs that lay claims to and define particular aspects of social or economic life. While discourses and rationales presumably included what Abbott (1988) called professional claims, they were seen to encompass broader claims to governing economic life. On the other hand, techniques were seen as specific inscriptions involving methods of recording, classifying, monitoring and

appraising specific practices from a distance.

As Miller and Rose (1990) pointed out, no political program was complete without an associated technique that offered the promise of realizing its aims. Robson (1991) took this to mean for accounting regulation that problematization resulting from translating discourses and rationales could render specific accounting techniques as problematic and might thus provide the motive for altering the accounting conventions. Eventually, solutions to a problematic technique were seen to *emerge*. Although the solutions were likely to be 'worlds apart' from any intended outcome, it was in this way that accounting regulation was seen as mediating demands for governance. Relying on this framework of emerging regulation mediating demands for governance, Robson (1991) looked at the standard setting program in the U.K. He suggested that problems and worries regarding accounting and auditing practices became translated into the terms and ideals of a professional elite. However, as he pointed out, the emerging problems and solutions did not seem to be linked by any obvious, necessary or inherent consequentiality.

Robson (1994b) attempted to apply a similar framework to the case of inflation accounting in the U.K. He argued that non-accounting discourses that became translated into the technical discourse of inflation accounting were affecting accounting regulation. As an example, he considered the 'unfortunately timed' macro-economic discourses on indexation to intersect with the deliberations of the Sandilands Committee report to partly explain the rejection of current purchasing power concepts. In another paper, Robson (1994a) considered the different related arenas that came to condition the social environment in which the accounting debate on inflation took place. These included industrial relations, counter-inflation, industrial policy, and taxation policy. The paper concluded that the Sandilands Committee and its final recommendations could be seen as conditioned by discourses and rationales in these different arenas, all of which were seen to aspire to 'acting at a distance' through calculative practices. Accounting was seen as called upon to change in accordance with the 'problematization' arising from these aspirations.

While Robson's contributions had looked to the Burchell et al. (1985) notion of the

accounting constellation, Young (1994) examined three accounting issues in terms of the analytical notion of regulatory space (Hancher and Moran 1989). Regulatory space was seen as outlined 'by the range of regulatory issues subject to public decision'. Meanwhile, regulatory 'issues' were seen to be ideological constructions: their recognition and allocation to a particular regulatory arena was seen to depend on social actors construing the world in particular ways. It highlighted an analytical focus on regulatory issues rather than the organizational or cultural dimension of a specific national or international standard setting regime. As the abstract space of regulatory claims that crystallized around issues, it was seen not so much as a space in which dramatic changes occurred but rather as a space for tinkering with existing accounting practices. The notion of regulatory space was thus close to the notion of the accounting arena developed by Burchell et al. (1985). However, the concern was not so much with the co-evolution of rationales and accounting techniques, but with notions of appropriateness. For Young (1994), the process of accounting change was seen to consist of several stages: Constructing accounting conditions as problems; constructing accounting problems as appropriate for standard-setting action; and constructing solutions as appropriate resolutions to particular accounting problems. The FASB's actions were seen to arise from duties and obligations rather than anticipatory consequential decision-making and thus expressing a 'logic of appropriateness' (March and Olsen, 1989), which construed action as consistent with the expectations in regulatory space. Accounting claims and concepts of what accounting should be and what accounting should do were thus seen to establish bounds for accounting change.

Young (1996), in drawing on Douglas (1986), reemphasized that a social element underlies all 'thinking' and 'problem-solving'. In recognizing this social element within individual thinking, Young argued that individuals see answers as being 'right' only if such answers sustained their institutional thinking. Thus, the institutional commitments of individuals came to be seen to inhibit their ability to be converted by arguments that conflicted with these commitments. Young maintained that financial accounting could be regarded as an institution in this sense. With the addition of an accounting problem to the agenda of the FASB, a search was seen to commence for ways to classify the accounting problem into the

available accounting categories. To justify any classification and the selection of a measurement method reference was made to the institutional commitments encoded in the conceptual framework. In the case of financial instruments, rather than viewing financial instruments as a challenge to the existing accounting framework, the challenge was seen to lay in finding ways to fit financial instruments within this framework.

Table 2.5: Model of the regulatory arena

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
Model of the regulatory arena	Demands to govern (action at a distance)	Mediating demands for governance	Translating and interpreting demands; sustain institutional thinking

The model of the regulatory arena can be synthesized into our heuristic schema as presented in table 2.5. In contrast to contingency theory, the literature establishes no linear-causal relationships between arenas in the environment and accounting regulation. Rather, the focus is on events to illustrate how external rationales and discourses on demands for governance, or action at a distance, are being translated into and co-evolved with conceptualizations of accounting problems and solutions within the accounting arena. Accounting regulation and accounting standard are seen as contingent outcomes of a process of problematization through translation of shifting rationales and discourses of governance. In the context of this model, accounting theory appears as just one among several distinct bodies of knowledge, each of which establishes claims to calculation, partly by appropriating techniques from other bodies of knowledge.

Implications for this research

This review provides a rather selective reading of the literature on accounting regulation by analyzing the literature on accounting regulation into four broad models: the model of the ideal profession, the model of political lobbying, the model of professional jurisdiction, and the model of the regulatory arena. The above discussion of these models illustrated the considerable shifts that have taken place in research agendas over the last half-century. These shifts affected two aspects that are important for this research. One aspect was the

relevance of accounting theory or 'knowledge' for accounting regulation. The other aspect was the role of the social context of accounting regulation. The relevance attributed to accounting theory and knowledge may be seen as having made one full circle from high relevance (normative model) to irrelevance (positive model) and back to 'high relevance' (arena).

In the normative model of the ideal profession, accounting guidance was to be *deduced* from axiomatic accounting theory. In contrast, the positive model of political lobbying disregarded the possibility that accounting theory would have an impact on accounting regulation, except for its rhetorical value. Accounting theory was seen to lag accounting regulation and play a secondary role as a means for providing justifications. In the model of the professional jurisdiction, accounting theory became primarily considered in its role to provide external *legitimacy*. While the literature emphasized the importance of knowledge for diagnosis, abstract knowledge was also seen as contributing to the cultural work in redefining task areas. In the model of the regulatory arena, accounting knowledge was seen to *translate* demands and *frame* what could be called notions of appropriateness of accounting representations. Accounting theory thus came to be an important element of the institutional structure of accounting for constructing appropriate problems and solutions of regulation.

While both the normative model and the model of the regulatory arena assigned an important role to abstract knowledge, the latter came to adopt a reflexive distance to normative theory. Indeed, this model turned normative theory into an important object of analysis as far as it could be seen to inform notions of appropriateness of accounting problems and solutions. Under a normative position, standards were seen to serve the purpose of the ideal profession in providing better guidance. In the reflexive position, the focus was on the shifting notions of appropriateness informed by the normative models and their implied constructs of value, performance, information and risk. Before, accounting theory had been seen to support the search for better guidance by developing fundamental axioms from which standards could be derived. Now, the different theories of accounting that were seen to produce and reproduce the meaning attributed to accounting became

objects of empirical analysis.

The second aspect concerned the social context in which accounting regulation was seen to take place. The literature promoting political lobbying models of accounting regulation came to challenge the functional model of the ideal profession in the late 1970s. Instead of considering an inherent functional purpose of accounting, interested external constituents became the focal point of the analysis. These external interests were seen to capture standard setting and to influence directly its outcomes. In contrast, the literature on the professional jurisdictions considered exclusiveness. It thus came to de-emphasize the direct impact of constituents on the professional realm while emphasizing the indirect impact constituents had as audience for professional claims. In jurisdictional battles between professions, standardization and abstract theory supporting codification became means to strengthen jurisdictional claims (Abbott 1988) and social capital (Bourdieu 1992b) in the eyes of the public.

Table 2.6: Contrasting models of accounting regulation

Model of accounting regulation	Source of demands	Role of standards	Role of accounting theory
Normative model of the ideal profession	Functional role of accounting	Rules for accounting practice	Deductive theory drawing on fundamental axioms
Model of political lobbying.	Interest of external constituents for representation of firm performance and value	Affecting payoffs	Providing excuses
Model of professional jurisdictions	Professional claims to task areas (social capital)	Strengthening jurisdictional claims (social capital)	Providing legitimacy
Model of the regulatory arena	Demands to govern (action at a distance)	Enabling action at a distance	Translating and interpreting demands; sustain institutional thinking

The relationship between the accounting arena and other regulatory arenas was considered more comprehensively in the model of the regulatory arena. As in the model of the professional jurisdiction, the relationship between accounting regulation and social environment was seen to be indirect, translated and thus contingent. However, unlike the professional jurisdiction model, the concern was not so much with the interest of specific

agents or groups that were seen to impact on the accounting arena, but with 'governmentality' by the state more broadly (Foucault 1979). Accounting was understood as a vehicle for action at a distance, thus stressing the constructive role of accounting in making things calculable and amenable to 'action on action'. The political lobbying model considered external demands as the analytical point of departure. Instead, the model of the accounting arena explicitly considered the circularity between the construction of accounting objects and the purposiveness of accounting regulation.

The research presented here shares the analytical level with the tradition discussed and summarized as the model of the regulatory arena. It shares in particular the concern about bodies of knowledge, their constructive role in making things visible and the way they come to change. It is interested to find out about the roles different bodies of knowledge play in the development of accounting standards. Meanwhile, a challenge of working with this research tradition is that different contributions tend to assign different meaning to the same terms and appeal to different traditions in the social sciences.[38] The same term used in different papers may not denote the same phenomenon. Therefore, the remainder of this chapter attempts to make explicit the way the theoretical concepts appealed to in this thesis are understood.[39]

The object of analysis of this thesis is what will be referred to as a *regulatory debate*. A regulatory debate consists of *contributions*. It can be observed in terms of specific contributions to a specific regulatory 'issue'. The notion of the regulatory debate is thus close to Burchell et al.'s (1985) 'arena' and similar to what Hancher and Moran (1989) have called 'regulatory space'. As an analytical concept, the notion of the regulatory debate emphasizes contributions to issues, rather than contributions within the confines of an organization or a particular regulatory regime. However, rather than emphasizing the spatial

[38] One of the most central and obviously ambiguous terms is 'institution'. Different contributions in the recent accounting literature appeal, for example, to North (1981); Giddens (1984); Douglas (1986); Coase (1988); March and Olsen (1989); Coleman (1990); DiMaggio and Powell (1991a); Fligstein (1991); Granovetter (1992); Polanyi (1992); Luhmann (1995); Callon (1998); Emirbayer and Mische (1998).

[39] Apart from the authors referenced, this section owes many ideas to Luhmann's (1995) conceptualization of social systems.

aspect of regulation, the notion of 'regulatory debate' intends to emphasize the temporal aspect of a series of contributions. Over time, a regulatory debate may easily cross boundaries of regulatory regimes and organizations. Potentially, the boundaries of any regulatory debate may be unlimited.

This notion of regulatory debate poses an empirical problem though. Considering any *intended* contribution to a regulatory issue might go as far as considering any private conversation as part of a regulatory debate. Clearly, although theoretically consistent with what is at stake, this would not be a very helpful starting point for conducting research, giving rise to the question what the boundaries of the regulatory debate are. The literature appealing to the model of the accounting constellation implicitly assumed boundaries between different arenas making up a 'constellation'. Distinguishing between arenas *within* a constellation presumes, however, that there are topical boundaries between different arenas - otherwise a constellation might just as well be referred to as an arena. Furthermore, the argument advanced in the literature is that arenas co-evolve and influence each other, highlighting the porous nature of the boundaries between regulatory arenas (Burchell et al. 1985; Miller and Power 1992). Meanwhile, if the boundaries of regulatory arenas are too porous, how may we keep on referring to distinct accounting arenas?

Burchell et al. (1985) in considering the *topical specificity* of arenas suggested referring to the accounting arena as comprising those debates that are concerned with the 'explication of standards for corporate financial reporting'. We may adopt this characterization and consider those topical debates that concern financial representations of entities constructed by accounting classifications as debates of accounting regulation. These debates thus concern the financial representation of firms and their involvement with their economic environment. Accounting debates can thus be seen to involve a topical selectivity in terms of an implicit distinction between financial and non-financial (Hines 1988) or, as we may say, between 'appropriate for accounting' and 'not appropriate for accounting'. We may consider this selectivity as the *notions of appropriateness* of the accounting debate. Topical notions of appropriateness may thus be seen to inform understandings of what may and what should be represented in financial reports.

Meanwhile with respect to the specificity of contributors, the *boundary* of contributions and contributors of the specific debate studied in this thesis - accounting for financial instruments - shall be considered by an internal and in an ideal-typical way empirical criterion. The criterion shall be the importance attributed to any particular contribution within the debate. Any contribution that is subsequently considered relevant shall by this virtue be part of the debate. The boundaries are thus established by the debate rather than by selective classification criteria of an external observer, who may have certain *a priori* ideas about what is appropriate in accounting for financial instruments. Irrespective of the intention attached to any contribution, the regulatory debate can thus be seen as *self-selecting* those contributions that come to be part of it. The relevance of any contribution might be observed in terms of subsequent citations within the debate or in other forms of cross-reference. Meanwhile, to research the regulatory debate stylized like that involves starting out from somewhere. In this thesis, we shall start out from what came to be considered 'important' contributions in the public domain, that is, in the relevant public press. We may then gradually thread outwards from these important contributions to include relevant contributions referred to in the initial contributions.

At this point, we should point out in more detail what is meant by *contribution* and who and what *contributors* are. As suggested here, the regulatory debate may be seen as potentially unbounded in terms of its contributions. At any point in time, regulatory debates may come to draw on a variety of different actors as *contributors*. We may classify these contributors either as *experts*, *organizations* or *ideas*. Debates on accounting regulation can be seen to draw on regulators, lobbyists, practicing accountants, academics, politicians and others. However, apart from experts and organizations they also draw on pragmatic as well as on abstract ideas and bodies of knowledge. Furthermore, at any point in time, regulatory debates come to involve *specific* ideas, experts and organizations as contributors. To characterize these specific contributors at a specific point in time, we may refer to the notion of a *meaning-reproducing network*. This notion resembles the notion of the fact-building network appealed to by Latour (1987).[40] At any point in time, such a network of contributors

[40] See also Latour (1996) and Miller (1997).

can be seen to be involved in the regulatory debate in support of 'facts'. As we might say in the context of accounting regulation: the network supports specific notions of appropriateness of accounting problems and solutions.

This notion of the meaning-reproducing network comes to highlight the temporary *structure* of the regulatory debate. The meaning-reproducing network constitutes and stabilizes the boundaries of the debate by selecting contributions. Thus, rather than considering the regulatory debate as *a priori* confined to a specific logic, it is the supporting network that temporarily stabilizes its structure by selecting contributions and contributors and thus stabilizing notions of appropriateness. As supported by the emerging and changing network links, a regulatory debate can be seen to maintain but also shift its notions of appropriateness of accounting problems and solutions as the supporting network restructures. The network maintains a temporary selectivity as well as a certain idiosyncracy. As will be studied in the next chapters, this idiosyncracy can be seen to accommodate demands for external interference as well as to support the reproduction of meaning to provide credibility to emerging guidance.

Referring to the process of regulation in terms of networks has become well established in other areas of policy research (Atkinson and Coleman 1992; Emirbayer and Goodwin 1994; Marsh 1998). While some research has attended to the role of ideas (Singer 1990), most of this literature remains actor-centered, however. In contrast, the notion of the regulatory debate suggested here allows focusing on the roles played by concepts and ideas, along with actors and organizations, in supporting notions of appropriateness. Within a regulatory debate analyzed in terms of its emerging network characteristics, certain core ideas can be seen to gain importance. Often these core ideas are not explicit, but implicit. The analysis presented here refers to *models of the firm* to describe such core ideas. They can be regarded as *models of the firm* in the sense that they render meaning to the relationship between an entity and its economic environment. These ideas about accounting entities, synthesized as meaningful models that are not necessarily bound to actors, can be seen to inform notions of appropriateness.

As has been pointed out in the literature (Young 1996), notions of appropriateness of problems and solutions can be seen as shaping institutional thinking in accounting regulation. However, rather than considering *accounting* as such to be an institution, this thesis refers to *institutions of accounting regulation* that are informed by certain understandings, or models about the role of accounting. These institutions are observable at different levels in terms of implicit models of the firm or, more broadly, as meaning attributed to accounting. Hopwood (1987) pointed out that accounting knowledge maintains a relationship with practice through the process of accounting regulation. It is because the two dimensions of the practical and the abstract can exist independently that abstract accounting knowledge can provide notions of 'what accounting is not' and thus give rise to accounting change. By focusing on the constitution and change of notions of appropriateness within the regulatory network, the concern is to learn about the emergence and change of these institutions of accounting regulation. Conceptual commitments can be seen to guide regulatory debates and allow accounting to make sense. This sense making and the shifting meaning given to accounting in the regulatory debate will be discussed in the next chapters.

CHAPTER THREE:

Rise of the IASC and its financial instruments project

Rise of the IASC and its financial instruments project

Abstract

The financial instruments project by the IASC that originated in the late 1980s reclaimed off-balance sheet transactions as accounting objects by subsuming them under the notion of 'financial instruments'. The project illustrates how international accounting regulation evolved in reference to reforms in banking regulation, growing public concern about creative compliance, uncertainty about the future of international accounting standard setting and standard setting initiatives at national levels. Drawing on the notion of the regulatory debate introduced in chapter two, this chapter analyses the early international project (1988-1991), which gradually came to shift notions of appropriateness of accounting problems and the suggested boundaries of what accounting can and should represent even though E40 was not successful.

Introduction

The international project on financial instruments was put formally on the agenda of the IASC in 1988. It set out very early to venture beyond U.S. and other national guidance and to enter new regulatory territory: accounting for the risks associated with contracts contingent on future events. U.S. accounting principles had established international benchmarks for guidance in the area of innovative financial contracts since the FASB had formalized hedge accounting for foreign exchange exposures in 1981 (SFAS 52) and futures contracts in 1984 (SFAS 80).[41] While FASB subsequently gave priority to disclosure and restricted guidance for recognition and measurement to *specific* financial contracts, the project undertaken under the auspices of the IASC came to aim for a *comprehensive*

[41] In an attempt towards international harmonization, Canadian and U.K. guidance on foreign currency translations was revised in the early 1980s in consultations with FASB (Davies, Paterson & Wilson, 1997, p. 468). IAS 21, issued in 1983, followed a similar basic approach as FAS 52, and dealt with limited aspects of hedge accounting. It was, however, seen to allow a FAS 80 approach for hedging of anticipated transactions (Bloomer, 1996, p. 311; Cairns, 1999, pp. 724-725).

standard to cover recognition and measurement for all varieties of financial instruments.

The IASC project went on for more than three years before the first Exposure Draft E40 was published in September 1991. With hindsight, this early phase was brief compared to the time it took to develop approved standards: guidance on disclosure (IAS 32) was not issued before 1995 and more than a decade passed before the first recognition and measurement standard (IAS 39) came into existence in 1999. Although it bore some resemblance with the latter in its mixed approach, E40 was eventually rejected in 1993. However, the early exposure draft established some of the conceptual building blocks that became points of reference in the subsequent project. In particular the notion of 'financial instruments' and the associated scope decisions came to shift the understanding of what accounting can and should make visible and fundamentally shifted the notions of 'appropriate problems' of accounting.

The conceptual dimension of accounting regulation revealed in this case challenges the perspective that collapses standard setting into 'capturing' by interest groups. Other researchers have highlighted the conceptual dimension of accounting regulation before. As discussed in more detail in chapter two, the literature suggested considering accounting regulation as an intellectual endeavor with respect to providing excuses (Watts and Zimmerman 1979), translating of regulatory demands (Robson 1991), supporting professional jurisdictional disputes (Power 1992), informing notions of appropriateness of problems and solutions (Young 1994), and institutional thinking (Young 1996). The case of financial instruments discussed here emphasizes the role of regulatory debates as intellectual projects involved in changing the meaning of accounting by changing notions of appropriateness of problems and solutions, the intellectual endeavor involved in making sense of accounting for economic entities and the risks they are seen to face. It is in the sense of shifting of such understandings about economic entities and the way they are accounted for that we may consider accounting regulation as an intellectual field that shapes the structure of the regulatory debate as well as the margins of accounting.

This chapter analyses the way in which particular understandings and meanings of

appropriate problems as well as their regulatory solutions (Young 1994) emerged within the international context. It looks at the mobilization of different experts, organizations and bodies of knowledge in shifting the understanding of what financial reporting can and should make visible. The chapter highlights the way in which actors of what we have come to call a meaning-reproducing network were structuring the debate and become connected to establish new ways of making things visible. In reference to the notion of fact-building networks (Latour 1987; Latour 1996; Miller 1997) these actors were seen to comprise individuals, but also bodies of knowledge and organizations.

As discussed in more detail in chapter two, related research in accounting has highlighted the mobilization of different bodies of knowledge in accounting regulation, in particular in the context of jurisdictional contests (Abbott 1988) between different groups of experts involved in accounting regulation (Power 1992; Robson et al. 1994; Pong 1999). This chapter shares the analytical level with the jurisdiction literature as it is interested to find out how particular bodies of knowledge came to inform notions of appropriateness of accounting problems and their subsequent solution. It tries to illustrate how these notions of appropriateness emerged in a network of ideas, experts and organizations.

The issue of financial instruments first surfaced at the boundaries of accounting with banking regulation and law in questions like: what are the 'modifications which may be needed to [the] measurement of capital adequacy in respect of some of the most significant off-balance-sheet activities'?[42] To what extent may legal definitions of ownership prevail over accounting notions of substance, or to what extent can 'any emphasis on substance over form be at the expense of compliance with the law'?[43] Attempts to address banks' off-balance sheet risks using non-accounting measures came to challenge accounting claims to making visible financial risks of banks. This challenge only slowly came to be translated as a more general accounting problem appropriate for regulatory action. In this process of problematizing, banking regulation became an important catalyst. The regulatory debate was

[42] BIS (1986), p. 19.
[43] The U.K. Department of Trade and Industry voiced this particular concern about a case involving Argyll Foods, as cited by the FT, 20 December 1985.

initially concerned with 'off-balance sheet risks of banks' and 'creative accounting' issues linked to financial engineering. It gradually came to address the problem of representing risks of *all* financial instruments that public reporting entities, not just banks, were party to.

This shift in the appropriateness of accounting problems involved considerable conceptual rethinking of the premises of accounting. The new premises about what accounting can and should make visible emerged within a closely-knit international network of experts, concepts and organizations. While some of the solutions suggested in the first international Exposure Draft E40 failed to gain acceptance, they nevertheless shifted notions of appropriateness of accounting problems and thus established a regulatory agenda that remained alive throughout the 1990s.

This chapter is organized as follows. It first discusses the regulatory issues that emerged at the margins of accounting (Miller 1998), in particular off-balance sheet risks of banks and creative compliance. The chapter then addresses the regulatory void in international accounting regulation during the late 1980s and the claim IASC put to it by virtue of its financial instruments project. It then illustrates how new accounting classifications emerged in the course of the project and came to establish appropriate problems although proposed solutions did not receive sufficient support from constituents. It closes with a discussion of the structure of the international regulatory debate in accounting that emerged in the early 1990s.

Emerging debates

In the late 1980s, the boundaries of what financial accounting can and should represent became subject to a dramatic shift. New projects were taken up by all major accounting standard setters in what came to be seen as a response to the 'new economic reality'. An increasing sophistication of the business world and swiftly growing financial markets characterized this new economic reality. Financial engineering was seen to allow firms to change the substance of their economic relationships without appropriate reflection in accounting. Demands for changes in accounting regulation emanated in areas such as prudential banking regulation (BIS 1986; OECD 1987), where regulators were seen to

establish risk measures separate from accounting numbers. In particular, two issues - off-balance sheet risks of banks and creative accounting - came to problematize the accounting claim to representing financial contracts, thus acting as a catalyst for accounting reform (AICPA 1985; ICAEW 1985; Tweedie and Whittington 1990; Tweedie 1993).

Representing off-balance sheet risks of banks

The U.S. Glass-Steagall Act of 1933 had separated investment banking from traditional commercial banking (Benston and Kaufman 1997). Banks in most jurisdictions remained highly regulated until the early 1970s with licensing and restricting the scope of banking operations as the main means of regulation. The 1970s and 1980s saw the emergence of new financial markets and changes in the style of banking regulation (Ellinger and Lomnicka 1994; Vieten 1996; Jackson 1997; Bessis 1998). These regulatory changes eased some of the restrictions on the banking industry and, as commercial banks were seen to face increasing competition and fast changing markets, they increasingly were seen to be looking for lucrative business alongside their traditional activities. The fast changing business environment was soon creating an imbalance between banking activities and regulatory tools, in particular after a series of banking crises, the most prominent of which became the savings and loans crisis in the U.S. (Young 1995).[44]

In the U.K., the Banking Act 1987 abolished the previous two-tier system and increased the number of inspection visits by the Bank of England, following recommendations made in a White Paper on Bank Supervision in 1985. These changes in banking regulation came to give a more prominent role to accounting. Banking regulators in the mid-1980s came to rely less on rules to segment the industry as barriers to risk-taking but on authorization and prudential rules to ensure the regulatory purpose. These prudential rules in banks and for banks came to rely on the core of financial statements produced under the jurisdiction of

[44] Calls for changes of the U.K. regime received backing after the collapse of Johnson Matthey Bankers Ltd. (JMB) in 1984 (Ellinger and Lomnicka 1994). Banking supervision following the U.K.'s 1979 Act had still depended on classification of deposit-taking institutions. JMB, which had enjoyed the status of a recognized bank, was seen to go into liquidation as a result of a substantial number of loans granted to just a few customers. In the aftermath of what came to be called JMB affair, it was pointed out that if JMB had been subjected to the more stringent supervision applied to non-banks, its financial difficulties might have been discovered earlier.

accountants. They were based on simple accounting numbers, such as solvency and liquidity ratios, which related assets and liabilities in specific ways (Miller and Power 1995). In view of this role of accounting in banking regulation, the representation of off-balance sheet risks of banks in accounting did become problematized. Banks were seen to enable internal visibilities of financial risks that became only partly reflected in their external financial reports.

As they assumed other activities besides commercial banking, banks were seen to split their assets and liabilities into two major portfolios according to the way these portfolios were internally managed. The traditional banking portfolio consisting of lending and deposit taking, which commercial banks were mainly involved with, and the market portfolio, which banks were actively trading.[45] The relative weight of these major categories was seen to vary according to the core business of the bank. While commercial banks were more involved in the business of collecting deposits and lending, which made up the banking portfolio, investment bankers were seen to concentrate on the business of market trading, making up the market portfolio.

> *Financial institutions ... if you look at the way that they break down various management information, management accounts, whatever, you tend to find that the business unit, or whatever that is broken down into, will fall into one or the other category.*[46]

A typical balance sheet of a bank would thus be an aggregate of differently managed categories of transactions: treasury and market transactions on the one hand and intermediation with lending and deposits collecting on the other. Since the 1980s and depending on the jurisdiction, some off-balance sheet assets and liabilities, such as contingent liabilities would also be included on the face of the balance sheet, but below the

[45] After lobbying from banks, the U.K. standard setter took account of the distinction between these two portfolios in Financial Reporting Exposure Draft (FRED) 13, par. 65: "Most banks and certain similar institutions have a trading book, which they manage separately from their non-trading book. The trading book comprises assets and liabilities arising from the trading activities of the entity. [...]" And paragraph 66 states: "The non-trading book comprises all the entity's other assets and liabilities, including various structural and strategic positions and those other assets and liabilities arising from commercial banking, or non-trading, activities. The non-trading activities include: (a) traditional lending and deposit-taking; (b) asset/liability and liquidity management; (c) investment activity, including activity of a strategic nature; and (d) related hedges."

[46] Interview S, August 1998.

bottom line. The income statement also reflected the different underlying types of transactions. Although the practice varied, in the income statement banks essentially constructed their accounting performance in reference to contribution margins, calculated at various levels of the income statement. In many cases, level and variance of these line items, established benchmarks for general management and risk management policies and analysts would be expected to gauge a certain part of the banking risk from the three core components of income:

> *If you look at our earnings ... major components are going to be - three major components - net interest income, which is by far the biggest, effectively fee income, and what I would call sort of dealing profits. Now dealing profits can be quite difficult to predict sometimes, but over time an analyst can track how much dealing profits form a percentage of your total earnings and whether or not they are particularly volatile.*[47]

Meanwhile, most of the variability of operating profits of commercial banks before provisions was seen to derive from the instability of interest margins as a reflection of interest rate risks and liquidity risk the bank was seen to be subject to. In internal bank management, and with the increasing sophistication of treasury operations, the interest margin therefore received considerable attention and became one of the main targets of increasingly sophisticated asset-liability management policies. These involved hedging strategies and transfers of risks between the banking and trading books. As one banker pointed out:

> *And you have a choice. You either manage that interest rate risk in the commercial bank, which is not what we do ... or you transfer that risk to a highly specialist central group of experts, who will then look at the risk across the financial bank. ... And then there is an asset and liability management committee, which meets very regularly to look at the risk in that book and to manage that risk with the intention of actually managing the net interest income stream for the commercial bank to hopefully stabilize it over time. So that risk transfer process is quite ... it's a core feature. And my understanding is that there are a number of other banks around the world who do that.*[48]

Asset liability management allowed managing interest rate risk across the banking and trading books. At the same time, financial risks other than credit risk, that were reflected in

[47] Interview U, October 1998.
[48] Interview U, October 1998.

provisions, did not become visible in the core financial statements. Their visibility was demanded for internal management though and, for example, by rating agencies to be reflected in the general credit rating of financial institutions. In addition to the increasing dichotomy between internal and external representation of risks, an increasingly problematic drawback of accounting based measures of financial risks became that they involved arbitrary adjustments. In particular, the risk adjustment expressed in the provision became widely seen as a way to smooth earnings (Goodfellow 1988; Milburn 1988a; Bessis 1998). In times of rising asset prices conservative accounting was seen to create hidden reserves and room for discretionary changes of the net asset position.

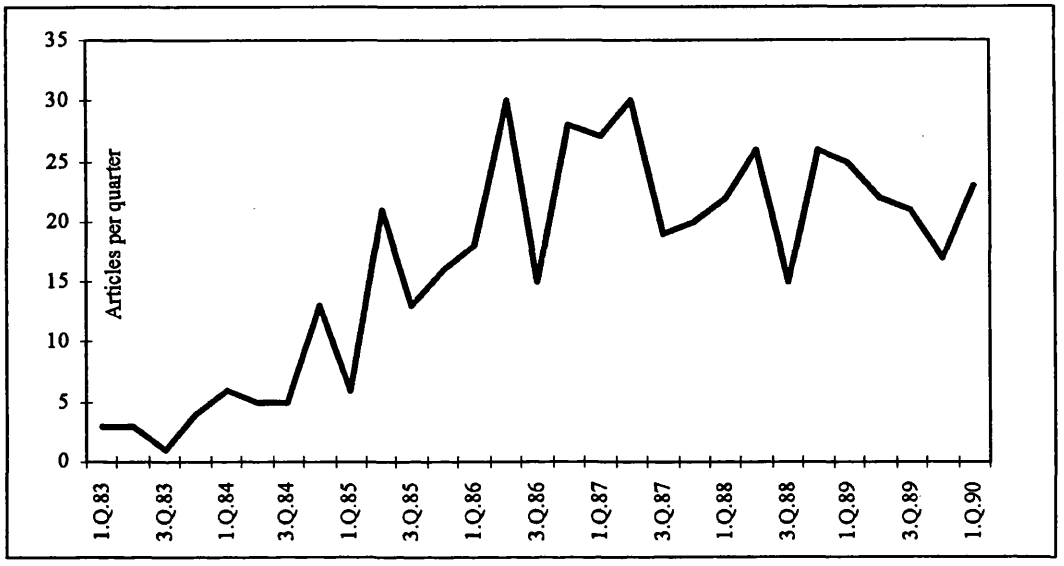
Furthermore, when corporates and banks started to engage in leasing and securitizations of assets, the traditional measure of solvency suffered. Leasing in the 1970s and securitizations in the 1980s were seen to reduce the visible asset portion of the balance sheet. For example, the notion of solvency that was seen to link wealth and liquidity relied on the distinction between assets of different maturities. This became seen as increasingly problematic for indicating the riskiness of reporting entities, particularly banks. While capital adequacy rules were increasingly coming to rely on accounting number as banking supervision made the legislative technique of authorization and licensing central to the regulation of banks (Cranston 1997; Jackson 1997), accounting came to be seen as incomplete or even misleading in representing financial risks.

The notion of 'off-balance sheet risks' thus came to crystallize a perceived insufficiency of accounting numbers in view of the demands of external visibility of financial risks and banking regulation. The efforts by banking and accounting regulators to deal with off-balance sheet issues was seen to gain its public support from banking failures in most developed countries in the early 1980s (Goodhart 1995; Gup 1998). In the public mind the reference to off-balance sheet risks, reached a first peak in 1986, lagging a professional and academic concern with off-balance sheet financial instruments that can be traced to the early 1980s.

As pointed out in figure 3.1, in the course of the 1980s risks of off-balance sheet financing

schemes, such as guarantees, project finance and non-consolidated subsidiaries, received increasing public attention. The average number of articles in the Financial Times (FT) referring to 'off-balance sheet' risks gradually increased from just ten in 1983 to over one hundred in 1987.

Figure 3.1: Number of FT articles referring to off-balance sheet risks[49]



Source: FT Profile

Most of the concern was directed towards off-balance sheet risks of banks associated with banking regulation. In 1984, a working group under the umbrella of the Basle Committee of Banking Supervision initiated a project on reporting the risks of banks' off-balance sheet contracts.[50] The working group's concern about off-balance sheet transactions was expressed in a letter to the British Banking Association (BBA) as follows:

> At our meeting, we noted that the volume of off-balance sheet transactions and the proliferation of new instruments and techniques had been growing rapidly. All Governors agreed that these innovations, which in part reflect changing technological and competitive conditions in financial markets, can involve risks that are difficult to assess and to quantify because of their complexity and because there is little historic

[49] Based on a full-text content analysis of FT articles between 1983 and 1990.

[50] The Basle Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basle, where its permanent Secretariat is located.

experience upon which to base judgments.[51]

As prudential regulation required the provision of minimum levels of capital to match exposures entailed in assets, matching of assets with regulatory capital was coming to be limited to on-balance sheet items. With the savings and loans crisis in the U.S. and a series of banking failures in Europe still in the public memory, banking regulators were looking for ways to include off-balance sheet items in the calculation of regulatory capital. As the report by the Basle Committee emphasized:

> The main conclusion ... is that the individual types of risk associated with most off-balance-sheet business are in principle no different from those associated with on-balance-sheet business. It therefore suggests that off-balance-sheet risks cannot and should not be analysed separately from the risks arising from on-balance-sheet business, but should be regarded as an integral part of banks' overall risk profiles ...[52]

This, however, came to reflect a different understanding of the significance of accounting numbers. Instead of relying solely on accounting, when banking regulators subsequently discussed new risk categories to address the risks of financial instruments they tried to rely instead on crude non-accounting classifications that considered relative credit risks inherent in different classes of instruments:

> The Committee felt that it would be helpful to set out what its members generally agree to be the relative degrees of credit risk arising from the different types of business. ... The translation of these relative degrees of risk into management tools and supervisory risk assessment measures poses considerable theoretical, practical and, in some cases, legal problems. ...
>
> In addressing credit risk, the Committee found it helpful to draw up a broad framework of analysis which distinguishes between four different categories of off-balance-sheet activity, namely guarantees and similar contingent liabilities, commitments, market-related transactions and advisory, management and underwriting functions.[53]

With these categories, banking regulation departed from traditional notions of risk

---

[51] Letter from the Governor of the Bank of England to the President of the British Bankers' Association, 16 September 1985.
[52] BIS (1986), p. 2.
[53] BIS (1986), p. 8. The focus at that time was primarily on credit risk and it was assumed that other types of risk were effectively proportional to credit risk (Pickering 1999). Around the same time, some banks like J.P. Morgan started working on quantitative measures of risk. These efforts eventually led to the development of value-at-risk (VAR) and related models (JPMorgan/Reuters 1996).

represented by on-balance sheet numbers. As capital adequacy aimed at setting uniform minimum levels of capital as a function of risks, banking regulators came to consider credit risk inherent in financial contracts irrespective of their accounting classification. In 1988, the resulting rules first came to be based on credit risk and, gradually during the 1990s, came to be extended to include market risk. The so-called Cooke ratio stipulated that the capital base, which includes at least 50% equity as well as subordinated debt, should cover at least 8% of risk-weighted assets. The weight scale started from zero for commitments with public counter-parties, up to 100% for private businesses with weights for banks and municipalities within the Organisation for Economic Co-operation and Development (OECD) countries set to 20% and for mortgage-backed loans to 50%. Off-balance sheet exposures got a weight of 50%. These Basle rules came later seen to have repercussion for the risk management of banks. As they established economic constraints they became seen to stimulate the development of internal risk management models and processes within banks (Vieten 1996; Bessis 1998). At the same time, regulatory capital requirements came to depart from financial accounting numbers (G-30 1993). Overall, financial accounting was seen to lose its role of making visible the economic exposures of banks by failing to present risks inherent in the new financial instruments. This failure became charged with concerns about competitiveness of banks in different national jurisdictions.[54] For example, with respect to providing regulatory capital for off-balance sheet risks, it was argued that there:

> ... are limits to how far the UK can go until other countries, notably the US, have taken similar steps, because it may only end up putting UK banks at a competitive disadvantage, and drive this internationally mobile business [investment banking] to more lightly regulated centres.[55]

Following its regulatory logic, the Committee on Banking Supervision highlighted that the way accountants presented the new financial transactions could have severe repercussions for financial institutions: the way they were structured, the stability of the banking system and the way in which banks competed internationally. Apart from their harmonization

[54] For example, the growing share Japanese banks had in the euromarket business became ascribed to their low capital adequacy requirements, thus leading the Bank of England and the Federal Reserve Bank of New York to call for harmonization of supervisory rules (Goodhart, 1995, p. 439).
[55] FT, 7 October 1985.

efforts for risk-adjusted capital, banking regulators thus came to challenge the appropriateness of accounting guidance in the area of off-balance sheet items:

> ... many supervisors consider that the information about off-balance-sheet exposures presently supplied in banks' published accounts is generally insufficient to give shareholders and depositors a reasonable picture of banks' activities. The supervisory authorities in Committee member countries would welcome discussions with the accounting profession in their own countries on all the issues raised in this paper, which have implications for management accounts and information systems as well as published financial accounts.[56]

Meanwhile, the most vocal constituents cherished conflicting ideas about the appropriateness of disclosures and accounting for risks of off-balance sheet instruments and who should mandate them. Even before and following the report by the Basle Committee on Banking Supervision, some national banking regulators had started calling on financial institutions to disclose off-balance sheet risks. Some regulators even started requiring banks to provide capital on a basis that was to be adjusted for off-balance sheet exposures. In other countries, bankers' associations addressed disclosure issues in the spirit of self-regulation (BBA 1991; G-30 1993). Many regulators and banks in particular rejected the idea of new international accounting standards. Gradually, however, the issue of off-balance risk became not only seen as an issue of prudential rules, but slowly gained significance as an accounting issue in the professional literature (Dieter and Wyatt 1980; Bohan 1981; Anonymous 1983; Nelson 1984), however, with little resonance in the regulatory debate of accountants. Eventually off-balance sheet transactions became publicly construed as an issue of greater transparency and presentation:

> ... there remains a broader issue ... Are purely advisory guidelines enough in modern circumstances? The Bank [of England] has already been edging, through its application of different capital requirements to different classes of risk, towards a somewhat more formal system. What it remains reluctant to do is to ally tighter control to greater transparency.[57]

However, the dominant understanding during the early 1980s seemed to be that banks' off-balance sheet risks appropriately had to be dealt with by banking supervisors. Only specific

---

[56] BIS (1986), p. 8.
[57] FT, 3 October 1984.

derivative instruments were to be addressed by dedicated standards, for example in the FASB's SFAS 80 on futures contracts. New notions of appropriateness of what accounting could and should represent did not emerge before 1986, when FASB eventually endorsed a project on 'financial instruments and off-balance sheet issues'. The long time it took to take up the issue suggests that the regulatory debate pursued by accountants lacked notions of appropriateness to construe the off-balance sheet issue as an accounting problem, as something demanding more comprehensive accounting guidance. And the initial FASB project came about only after an unprecedented intervention by the SEC, as one staff member of FASB recalls:

> *The chief accountant of the SEC wrote us a letter in 1985 and this letter said, 'hey you better hop on this financial instrument off-balance-sheet financing question, there is a real concern in this area'. And he took this unprecedented step of having this Security and Exchange Commission, the actual governing body, vote to direct him to send that letter, which we usually don't get. So this was a letter that came basically from the SEC saying, 'hop on it'. We've had a couple of things like that since, but I don't remember one before that.*[58]

Creative accounting

Accounting regulation had come to address the 'holes' in traditional accounting that had emerged during the 1970s in major Western jurisdictions, particularly in the context of leasing. Again, in the 1980s, new off-balance sheet and other financing schemes were seen to establish creative ways of circumventing balance sheet recognition of certain assets. While this mainly concerned banks, there was increasing evidence that corporations as well engaged in schemes that impaired the relevance of their accounting numbers (Dieter and Wyatt 1980; Griffith 1986; Tweedie and Whittington 1990; Smith 1992; Shah 1996). Accounting had become subject to creativity largely because derecognition of balance sheet items did rely on legal definitions of transfer. The techniques of creative accounting used a mixture of circular transactions with removal of legal ownership of the asset and the use of options. A widely cited example in the U.K. became the sale and repurchase contract used in the distilling industry. Maturing whisky inventories were sold to financial institutions but

[58] Interview Y, December 1998.

could be repurchased when required. The distillery would sell the whisky to a bank and give the bank an option to put the whisky back to the distillery at the selling price plus interest based on normal lending rates up to the date of repurchase. The distillery would have a call option with similar conditions. This ensured that the whisky returned to the distillery and that the distillery paid back the sales price plus interest, the effect of which was similar to a loan secured on the inventory (Tweedie 1993). As one of the experts involved in the IASC project explained:

> *We found a lot of these contracts would be drawn up putting in all sorts of conditions, some of which were quite remote but tended to show that the thing was sold. Whereas, when you looked carefully, you realized that there were other conditions, which simply brought it back to you in almost all circumstances.*[59]

The issue of recognition and derecognition became debated at the intersection between accounting and legal concepts of ownership (McBarnet and Whelan 1991; Napier and Noke 1992; Pong 1999). The accounting debate started with concerns that commercial effects could be misrepresented by transactions that relied on legal classifications. A number of financial contracts remained off-balance sheet, as they did not seem to have a value when they were entered into. In the field of securitization, a whole new industry was seen to emerge, which actively set out to blur the distinction between sale and financing and thus between on and off-balance sheet items. This primarily affected accounting in mature capital markets. And gradually, the appropriateness of accounting numbers to represent the transactions came to be challenged. As was explained in reference to the U.S. situation:

> *The FASB had two conflicting standards, on which a whole industry was built. They had a standard on transfer of receivables with recourse, which was SFAS 77 ... And they had a technical bulletin on the treatment of collateralized mortgages. The result of ... which went the other way. Transfers of receivables with recourse implied you could get quite a lot of things off the balance sheet. Treatment of collateralized mortgage obligations implied that you couldn't get them off the balance sheet. But in the typical American fashion it just depended which way you drew the contract up. If it looked like a collateralized mortgage, that is a loan, then you couldn't get it off the balance sheet. If you expressed it more as a sale and it came under 77, then you could. And the whole securitization thing just exploded in ten years - built essentially on 77.*[60]

---

[59] Interview P, August 1998.
[60] Interview P, August 1998.

The issue became gradually framed in terms of form versus substance (ICAEW 1985; McBarnet and Whelan 1991), however, in the early 1980s it seemed still rather unclear how to deal with the related recognition and derecognition issues (Dieter and Wyatt 1980; Anonymous 1983). Appropriate categories of financial assets and liabilities were not yet available and standard setters were left to deal with singular symptoms of a still undefined broader issue, which were like 'mushrooms popping up here and there in the field'.[61] In view of what became considered creative practices of lawyers and investment bankers, accounting regulation was increasingly seen to lose its grip on new financial arrangements (Shah 1996). And it took some time before the repercussions of the changing business environment came to shift notions of appropriateness in accounting regulation. While financial instruments were rapidly challenging the traditional way of doing business and managing risks, they only gradually came to be seen as 'challenging the traditional way accounting has been'.[62] Only slowly did notions of appropriateness of what accounting could and should represent come to shift.

Shifting notions of appropriate problems

During the 1970s, accounting had been seen to reclaim off-balance sheet items as accounting objects in areas such as leasing and long-term contingent obligations, first in the U.S. and later in other countries. By the mid-1980s, FASB became the first standard setter to develop guidance for specific financial instruments (FASB 1981; FASB 1983a; FASB 1983b; FASB 1984; FASB 1985b). Initially, however, this had led to accounting solutions that remained inconsistent. For example, the U.S. standard on futures (SFAS 80) contained a broad definition of a hedge that differed conceptually from the narrow definition of a hedge found in the standard on foreign exchange translations (SFAS 52) (Stewart 1989). The FASB's focus on separate instruments thus became characterized as 'piecemeal approach', as it sliced the project into components and dealt with each of the various components separately. Only by the mid-1980s did FASB start to look at the emerging financial contracts on a more comprehensive basis, as pointed out by a member of the Steering Committee:

[61] Interview a, December 1998.
[62] Interview F, April 1998.

We were looking for some sort of collective description of what we had here. And it seemed that these problems related to 'financial instruments', whatever they may be. It took us ... we had to work out a definition of that and off-balance sheet financing. So those were the two main areas. And then it ... there were several other aspects to it, debt versus equity questions - things you couldn't tell what they were - was one class of transactions. The whole question of hedging, of hedge accounting was clearly part of it ... [63]

In 1985, exploratory work by FASB and by the Task Force on Options of the AICPA (1985) had started and in 1986 FASB's 'financial instruments and off-balance sheet financing' project was officially taken on. This comprehensive project was to address more conceptually the issue of what had tentatively been tagged 'financial instruments'. The broad, yet initially undefined, term 'financial instruments' was seen to strengthen new notions of appropriateness, allowing the regulatory debate to address the mushrooming transactions under the umbrella of an intellectual agenda. It allowed conceptualizing the different off-balance sheet and creative instruments under a common category making them amenable to regulatory action. The notion of 'financial instruments' promised transforming contracts that had been off-balance sheet into 'recognizable' accounting objects. As intellectual support for the new category, references to 'claims to cash flows', originating in financial economics, were employed, as were conceptual framework definitions of assets and liabilities:

27. A *financial instrument* is any contract that is both a (recognized or unrecognized) financial asset of one entity and a (recognized or unrecognized) financial liability or equity instrument of another entity.

28. A *financial asset* is any asset that s (a) cash, (b) a contractual right to receive cash or another financial asset from another entity, (c) a contractual right to exchange other financial instruments on potentially favorable terms with another entity, or (d) an equity instrument of another entity.

29. A *financial liability* is any liability that is a contractual obligation (a) to deliver cash or another financial asset to another entity or (b) to exchange financial instruments on potentially unfavorable terms with another entity.[64]

Any contract that was seen to involve contractual cashflows or claims to cashflows fell under this definition shifting the notion of appropriateness of accounting problems. The

[63] Interview a, December 1998.
[64] FASB (1987), p. 11, original emphasis.

resulting accounting objects demanded accounting solutions and supported a new regulatory agenda for recognizing and measuring them. Still, this emerging regulatory agenda was considered to be one of the 'largest and most complex' with the 'least predictable outcome' that the FASB had ever adopted (FASB, 1986, p.1). And for what became seen as pragmatic reasons, the FASB decided to start the project with disclosure issues and to tackle recognition and measurement only at a later stage. However the new category of 'financial instruments' established an accounting issue and supported an intellectual agenda that eventually lent itself to adoption by the IASC in 1988.

Future of international standard setting

By the late 1980s, debates on banking regulation and creative accounting had nourished a sense among accounting regulators that increasing competitive pressures on preparers and audit firms led to bad accounting driving out good accounting (Beresford 1990; Tweedie 1993). The international nature of these pressures was seen to push harmonization up on the regulatory agenda. Thus, a number of international organizations came to address international accounting regulation, such as the United Nations' (UN) Commission on Transnationals, the OECD, the European Commission and, of course, the IASC.[65] The London-based IASC was still seen then as a 'volunteer' organization that operated close to professional bodies. It was seen to provide soft standards for less developed capital markets and to operated within tight budget limits, which did not allow it to undertake major projects. Meanwhile, the IASC had come to rely on a network of allies, among others some of the banking regulators. Banking regulators were interested in international standards for banks and in May 1988, Cooke, then the Chairman of the Basle Committee on Banking Regulations and Supervisory Practices, stressed:

> If supervisors are serious in their intent to move towards closer convergence of supervisory rules and practices for international banking business ... then they cannot afford to wait indefinitely for a greater degree of harmonization of accounting standards at the international level. ... The work of the International Accounting

[65] Both the UN Commission on Transnationals and the OECD were seen to be more broadly concerned about disclosures, transparency and codes of conduct by transnational/multinational firms, while the European Commission and the IASC had a more specific concern with improving and harmonizing accounting (Interview T, November 1998).

> Standards Committee can only be strengthened if supervisors join together to press for international harmonization in accounting rules and, importantly, are prepared to contribute to their development by the international accountancy standard bodies. More particularly, supervisors should give the profession every encouragement in its efforts to produce authoritative guidance on best practice in accounting and reporting for financial instruments. ... Having had contacts with the International Accounting Standards Committee almost since its inception, I do believe it seems to be developing some greater momentum and hopefully will increase in authority.[66]

As early as 1977 had the Basle Committee of Banking Supervisors first become involved - also financially - in an IASC project on banking. This project resulted in a discussion paper in 1980, but not in a standard. It was put on hold when the European Commission started debating a revision of its Bank Accounts Directive.[67] Another attempt by the IASC to develop a comprehensive standard for disclosure, recognition and measurement for banks, in 1984, failed to receive the assistance of the Basle Committee. Neither this nor the previous project had made reference to financial instruments as a separate accounting category. Eventually, in 1990, work on accounting for banks was deferred pending completion of the financial instruments project, which had shifted the broader regulatory agenda.

On the other hand, in 1986, as the Basle Committee issued its paper on capital convergence, the IASC had experts from the Basle Committee to assist in developing a disclosure standard for banks and similar financial institutions, which was issued in June 1990 (IAS 30). It received support not only from these banking experts but drew on abstract concepts that had emerged in the capital convergence work of the Basle Committee, for example, the classification of off-balance sheet items. The project also involved representatives of American and European banks and people responsible for the European Community's Bank Accounts Directive.[68] This collaboration became one important link in an emerging network that would later come to structure the international regulatory debate on financial instruments.

The Basle Committee of Banking Supervisors was also seen as the initiator for an OECD-sponsored symposium, which assembled representatives from around the world to discuss

---

[66] OECD (1988), p. 208.
[67] Directive No. 7763 was issued in June 1983 to augment the Council of the European Communities Bank Accounts Directive No. 77/780, which was issued in December 1977.
[68] Cairns (1999), pp. 906-907.

the accounting and disclosure issues relating to what was then referred to as '*new* financial instruments'. Participants included representatives from banks, corporations, accounting firms, standard setters, as well as national and international regulators. The symposium addressed *inter alia* the increasing gap between what was regarded as the economic reality of new financial instruments and their accounting treatment. As the Secretary-General of the OECD pointed out in the opening statement:

> ... new financial instruments have developed so rapidly that accounting principles have been unable to keep pace. ... In order to make good these shortcomings, rules for accounting treatment and disclosure need to be developed without delay ... [69]

Before and during the conference the view was strengthened that internationally harmonized accounting standards in the area of financial instruments may not only be regarded as an appropriate way to frame the immediate accounting challenges concerning banks. It became further seen as a vehicle to progress in international harmonization of accounting regulation. As the Chairman of the OECD Committee on Financial Markets, noted:

> The development of national accounting and disclosure standards for the new instruments is at an early stage. This provides an excellent opportunity for international co-ordination or harmonization, before positions have become entrenched.[70]

While the OECD might have been considered one of the appropriate institutions to address the issues within its mandate, the IASC came to propose organizational support for international harmonization and accounting for financial instruments. The IASC enforced its claim by framing the regulatory issue of banks' 'off-balance sheet risks' as essentially an accounting issue in a broader sense. The Board Member representing the IASC at the OECD conference in 1988 suggested a comprehensive and conceptual approach, shifting the notions of appropriate accounting problems even further. It was to focus on all business risks covering all financial instruments of all reporting entities, not just financial institutions:

> Accounting treatment should not view the new financial instruments as an isolated

[69] OECD (1988), p. 3.
[70] OECD (1988), p. 12.

> phenomenon ... Instead, this new phenomenon should be seen as only part of the broader issue of business risks. A conceptual rather than an ad hoc approach is needed. The real issue, then, is how to account for business risks generally. Emphasis should be laid on the coherence of information; disclosure should go for the whole story rather than the pieces making up the story, in order to be understandable by users. ...
>
> Financial instruments also affect enterprises other than banks - hence the decision of the Board of the IASC to set up a new project on financial instruments. Work on this new project has to be co-ordinated with that on banks and will also involve people outside the accountancy profession.[71]

The broad notion on 'financial instruments' suggested here transcended the international pre-conference debate, where representation of risks had been seen predominantly as an issue concerning banks and their regulators. Until then, most of the work for assessing risk-adjusted capital requirements for financial institutions had been undertaken by banking regulators. This statement associated the regulatory concern about off-balance sheet issues with the regulatory agenda of the IASC. In embracing the issue of financial instruments, the IASC was seen to strengthen its position in international accounting regulation (Zeff 1998). After the symposium, neither UN nor OECD put claim to setting standards in this area. In this sense, the OECD symposium became seen as a 'catalyst' for a technical project that had yet to be addressed internationally, as one expert recalled:

> *Really, the catalyst for the IASC to do something was the OECD conference in spring of 1988. And by that time, by the time of that conference, the IASC had come round to view that this really ought to be something to be dealt with sooner rather than later. We may well have decided at previous Board meetings that we had to - I think we had - that we had to address this issue. And the OECD conference in May 1988 really crystallized all that. ... And there was a lot of support there for the IASC to do it. ... People were looking to the IASC to do it, which is an interesting political shift. Because you went back, say, five years, the OECD probably would have said, we better do it ourselves. But by that time, the IASC's reputation was such that people were looking at the IASC to do it internationally.*[72]

Financial instruments had emerged as an appropriate international accounting problem and by June 1988 IASC's financial instruments project was officially inaugurated. Some national regulators had by then initiated further work on disclosure guidance for specific financial instruments. The French *Conseil National de la Comptabilité* had issued opinions

[71] OECD (1988), pp. 204-205.
[72] Interview X, November 1998.

on financial futures and interest rate options and the *Commission des Operations de Bourse* had issued a statement on disclosure about financial instruments for publicly traded companies. The German *Institut der Wirtschaftsprüfer* was in the process of developing rules for foreign currency and interest rate swaps. The U.K. Accounting Standards Committee (ASC) had issued a draft on special purpose transactions. The Canadian Accounting Standards Committee was developing conceptual guidelines to address the issues of off-balance sheet activities with a view to risk related disclosures for financial institutions.

None of these projects, however, aimed at addressing all potential varieties of financial instruments, except for the FASB that had started developing guidance under the umbrella of its comprehensive project, with a view to ultimately targeting all financial instruments. Meanwhile, as FASB had come to tackle disclosures of financial instruments first, the project provided an exceptional opportunity for IASC to be seen as leading international standard setting for their recognition and measurement. In taking on the financial instruments project, the IASC presented itself as a force alongside the leading national standard setters, as a former Board member who was closely related to the project recalls:

> *The IASC underwent ... a very dramatic change in its approach and its outlook in the late 1980s... Until that time it had been what some people would refer to as the lowest common denominator. In order to gain acceptability it packaged factors from the major countries. ... There are two main changes ... One was the adoption of the comparability project, which came to be known as the 'improvements project' ... and the U.S. representative at the time, Art Wyatt, became the Chairman of the 'financial instruments project'.*[73]

Along with the comparability project, the financial instruments project allowed the IASC to be seen as restructuring the way it worked, to emerge as an important force in international accounting regulation and to secure the support which it had lacked, for example in the international banking project. It seemed that the financial instruments provided the IASC with the regulatory problem it needed to strengthen its legitimacy internationally. The project thus became an important element in a wider regulatory game in which IASC was

[73] Interview d, December 1998.

seeking endorsement of its standards by IOSCO to establish standards that would be internationally acceptable. It received support in this endeavor by Europeans and some non-U.S. regulators that feared a domination of international accounting by U.S. Generally Accepted Accounting Principles (GAAP). It also received support from many professional accounting bodies interested in restoring the trust in financial reporting, which had severely suffered in the off-balance sheet and creative accounting debates of the 1980s. The structure of the emerging international network supporting the IASC project will be discussed in more detail in the following section.

Knitting an international network

The international network that the IASC associated with its project became seen as crucially important for its success and failure. In 1985, just before starting work on financial instruments, the IASC had approved a standard on investments (IAS 25). At that time, the IASC staff was also still working on the proposed comprehensive standard for banks. As IAS 25 dealt with marketable securities as assets and the banking project involved recognition and measurement issues, some technical recognition and measurement issues like derecognition and market-value measurement had already been explored by the IASC.

Table 3.1: Major events related to the IASC Exposure Draft E40[74]

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1977	E11: Foreign Transactions and Translation of Foreign Financial Statements (IASC 1977) Start of the IASC joint project on bank disclosures with Basle Committee	SFAS 20: Forward Exchange Contracts (FASB 1977)	ED 21: Foreign Currency Transactions (ASC 1977)
1978		Report on economic impact of SFAS 8 (Evans et al. 1978)	Fourth Directive on annual accounts (EC 1978)
1980	DP: Disclosures in Financial Statements of Banks (IASC 1980)		ED 27: Foreign Currency Translations (ASC 1980)

[74] A comprehensive list of the major events for the entire IASC project can be found in appendix A3.

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1981		SFAS 52: Foreign Currency Translations (FASB 1981)	ED 29: Leases and Hire Purchase Contracts (ASC 1981)
1982	IAS 17: Leases (IASC 1982)	SFAS 67: Real Estate Projects (FASB 1982)	
1983	IAS 21: Effects of Changes in Foreign Exchange Rates (IASC 1983)	SFAS 76: Extinguishment of Debt (FASB 1983a) SFAS 77: Reporting by Transferors for Transfers of Receivables with Recourse (FASB 1983b)	Seventh Directive on consolidated accounts (EC 1983) SSAP 20: Foreign currency translations (ASC 1983)
1984		SFAS 80: Futures Contracts (FASB 1984)	SSAP 21: Leases and Hire Purchase Contracts (ASC 1984)
1985	IAS 25: Investments (IASC 1985)	TB 85-2: Collateralized Mortgage Obligations (FASB 1985b) CON6: Elements of Financial Statements (FASB 1985a)	U.K. Companies' Act 1985 TR 603: Off-Balance Sheet Financing and Window Dressing (ICAEW 1985)
1986 March	Basle Committee on Banking Supervision report on banks' off-balance sheet risks (BIS 1986)		
May		Start of the FASB financial instruments project	
December		Reports on economic effects of SFAS 52 (Evans and Doupnik 1986b; Evans and Doupnik 1986a)	European Directive on banks and other financial institutions (EC 1986)
1987 November	Start of the IASC's comparability project	ED: Disclosures about Financial Instruments (FASB 1987)	
1988 March	IASC first envisages project on financial instruments		ED 42: Special Purpose Transactions (ASC 1988)
May	OECD conference on New Financial Instruments in Paris (OECD 1988) ED: Framework (IASC 1988)		
June	Start of the IASC's financial instruments project		
July	Basle Capital Accord (BIS 1988)		
September			Dearing Report (CCAB 1988)
1989 January	E32: Comparability of Financial Statements (IASC 1989a)		
April	Framework (IASC 1989c)		

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
July	E34: Bank Disclosures (IASC 1989b)	ED (Revised): Disclosure of Information about Financial Instruments (FASB 1989)	
1990 March		SFAS 105: Disclosure of Information about Financial Instruments (FASB 1990c)	
May			ASC ED 49: Reflecting the Substance of Transactions in Assets and Liabilities
July	Start of the IASC's improvements project		ICAEW: 'Marking to Market' (Macve and Jackson 1991)
August	IAS 30: Bank Disclosures (IASC 1990b)	DM: Distinguishing between Liabilities and Equity Instruments (FASB 1990b)	ASB formed
November	SOP: Financial Instruments (IASC 1990a)		
December		ED: Disclosures about Market Value of Financial Instruments (FASB 1990a)	
1991 June	First annual meeting of standard setting bodies		
September	E40: Financial Instruments (IASC 1991)	Report on hedge accounting (Bierman et al. 1991)	

Some of the conceptual disagreement that had surfaced in these projects was soon mirrored in the early debate on financial instruments. However, the project on financial instruments, in shifting the notions of appropriateness of what accounting can and should represent, was promising a more comprehensive approach for resolving many of these. Financial instruments thus received priority to the degree that the entire banking project was put on hold. One former project member pointed to this priority:

> *IASC treated financial instruments special. I think if you look at the working group, the Steering Committee, it was always bigger than other working groups. I think a number of countries pushed very hard, lobbied very hard to get on it when it was set up ... And I think it was seen as the first one where it was agreed that IASC wouldn't follow behind the [other standard setting] bodies but would try to be ahead of them ...*[75]

The IASC was aiming high. However, when it was started in June 1988, the financial

[75] Interview T, October 1998.

instruments project was weakly funded. Constrained by limited resources, staff and experience, the IASC's efforts to establish a legitimate project was seen to depend crucially on the external support it could secure. While the FASB and the IASC had by then introduced their conceptual frameworks, there was little basis on which to build classifications for making visible benefits and risks entailed in financial instruments. Overall, the IASC had not yet proven its ability to come up with innovative accounting guidance. The claim to address accounting for off-balance sheet risk and the IASC's claim to be ready for the job were still weak. The IASC project had to find support for its project that was to shift boundaries of what accounting can and should represent into the areas of off-balance sheet financial instruments. In view of securing collaboration the IASC Secretariat had stated in a note to the Board:

> There are ... three reasons why it should adopt immediately the topic of accounting and disclosure of financial instruments: (1) it is an emerging topic that concerns many countries and it is desirable that common solutions are obtained at an early state in the standard-setting process; (2) many financial instruments are international in character and it is preferable that all aspects of like transactions are measured and displayed in a consistent way; and (3) the involvement of IASC should help to conserve national standard-setting resources and encouraging national standard-setting bodies to work together.[76]

The IASC thus came to involve national standard setting bodies, the profession and external constituents such as banks and banking regulators in the project. This supporting network not only came to include experts and organizations, but also ideas and concepts. A number of representatives on the IASC Board had early indicated a keen interest to become involved in a proposed IASC Steering Committee on financial instruments, the formal centerpiece of the emerging network. These included the Professional Institutes of Australia, Canada and France, the International Coordinating Committee of Financial Analysts Associations, the Institutes of Japan, the Netherlands, the U.K. and the U.S. After the June 1988 Board meeting had approved the project, a Steering Committee was established. The Steering Committee eventually included representatives from Australia, Canada, France, Italy, Japan, the Netherlands and the United Kingdom. In addition, the IASC set up an international

[76] Staff note, June 1988.

Consultative Group, which included representatives from financial institutions, regulators of financial institutions, securities regulators, the business community, financial analysts, stock exchanges, the accountancy profession, the International Auditing Practices Committee and the OECD.

Table 3.2: Structure and membership of project up to Exposure Draft E40

Chairman	A. Wyatt	United States; Arthur Andersen (until DSOP)
	R. Murray	United States, Coopers & Lybrand (after DSOP)
Staff	D. H. Cairns	Secretary General, IASC
	J. A. Carchrae	Assistant Director, CICA
	R. M. Goligoski	Research Manager, IASC (from November 1989)
	P. Martin	Project Manager, CICA (after DSOP)
	R. K. Syal	Project Manager, CICA (first year only)
	M. Wovsaniker	Research Manager, IASC (until October 1989)
Steering Committee	Y. Bernheim	France, Banque Indosuez
	D.G. Boymal	Australia, Ernst & Young
	R. Costaguta	Italy (small firm)
	A. Kato	Japan, Coopers & Lybrand
	P.J. Maat	Netherlands, Erasmus University
	G.K. Routledge	Canada, Deloitte
	P.J. Stilling	United Kingdom, Touche Ross
Staff Observers	A. Carey	Consultative Committee of Accountancy Bodies, U.K. (CCAB)
	W.J. McGregor	Australian Accounting Research Foundation (AARF)
	T.W. McRae	American Institute of Certified Public Accountants (AICPA)
Consultative Group (as originally set up)	K.E. Boast	International Federation of Stock Exchanges (FIBV)
	A.V. Cook	International Chamber of Commerce (ICC)
	E. Damotte	Fédération des Experts Comptables Européen (FEE)
	P. Danjou	International Auditing Practices Committee (IAPC)
	C.C. Davies	Internat. Coordinating Committee of Financial Analysts Associations
	L. Herve	Organisation for Economic Co-ordination and Development (OECD)
	D.S. Howard	Citibank, American Bankers' Association (ABA)
	R. Langford	Lloyds Bank, British Bankers' Association (BBA)
	R. Lauver	Financial Accounting Standards Board, U.S. (FASB)
	R.J Reinhard	Securities and Exchange Commission, U.S. (SEC)
	T.M. Rybczynski	International Chamber of Commerce (ICC)
	D. Swanney	Basle Committee and Bank of England
	G. Timmerman	Fédération des Experts Comptables Européen (FEE)

The Steering Committee (see table 3.2) was chaired by Arthur Wyatt, an Arthur Andersen Partner and former Board Member of the FASB. Wyatt was the IASC Board representative for the United States and became IASC Chairman in 1990, when he handed chairmanship of the Steering Committee to Ron Murray. In 1986, when still a FASB Board member, Wyatt had taken a strong interest in the U.S. project on financial instruments and had participated in its Financial Instruments Task Force. He had earlier commented on off-balance sheet financing (Dieter and Wyatt 1980). During and after his years at the IASC, Wyatt became known as a supporter of international harmonization based on conceptual standards

(Carmichael and Craig 1992; Craig 1996).

While the project staff would do the drafting under the supervision of the Chairman, the Steering Committee would review drafts at various stages and submit them to the IASC Board.[77] As a reflection of the IASC's membership structure the Steering Committee came to consist of six members of the profession, five of which came from large international audit firms. Just one academic and one preparer were part of it. To mitigate this noted dominance by professional firms, the Consultative Group was expected to broaden the involvement and solicit comments from other constituents. It granted observer status and the right to comment on pre-exposure drafts to bankers, business representatives, financial analysts, the OECD and banking supervisors. Furthermore, the FASB became a member of this group, as did the SEC. As a former senior member of the IASC recalls:

> *We didn't just want Big Six people. But we ran into one or two political difficulties with the accounting bodies on that. ... So, we also set up a parallel advisory group - or Consultative Group was it called - which involved a whole range of bankers, regulators, a lot of other people involved in the process.*[78]

Although its formal role faded over time, the Consultative Group came to represent those organizations, and included some of the people, that had initially addressed the issue of off-balance sheet risks in the context of banking supervision. It thus established important links in the network that came to support and structure the international regulatory debate. Through representation in the Consultative Group, the banking regulation debate became more formally associated with accounting regulation. The Steering Committee was seen as the core working party and most of its members commented on drafts at the various stages of the project. The network allowed drawing on related debates, for example, by immediate involvement of the FASB and the SEC staff. And indeed, many Consultative Group members became very active contributors at the drafting stage of the project. A striking feature of this supporting network soon became the close links that a rather small group of experts came to entertain. Although acting as representatives of different organizations and

[77] This structure is quite distinct from the FASB process where Board members undertake the tasks of the IASC's Steering Committee as well as its Board.
[78] Interview N, August 1998.

constituents, a sense of shared expert status emerged among the people closer involved in the project. To the degree that it came to venture into uncharted territory, the project turned into a challenging intellectual enterprise:

> *But there was quite an open style of debate. There were some quite hard fought points. There was ... if I look back, actually, I would say they were a very friendly Steering Committee, but there were some quite open disagreements on various issues like 'should you recognize commodity contracts?' That was an early issue. And the particular Anglo-Saxons involved tended to be fairly relaxed, fairly open in exchange and so there were quite interesting intellectual arguments going on at times.*[79]

Before embarking on the financial instruments project, the IASC had undertaken several attempts to increase direct collaboration with national standard setters, often held back, however, by the professional institutes, its official member bodies (Cairns 1997). Despite this resistance, in the course of the project, the collaboration with national standard setters became increasingly important.[80] Apart from references to the work by the Basle Committee mentioned above, the project staff maintained close links with the concurrent U.S. debate. The IASC team had a series of conversations with the staff of the FASB. Thus, apart from the detailed comments FASB made at the various steps of the project, U.S. guidance was also directly incorporated into the drafting of the looming IASC standard, for instance with respect to the very definition of 'financial instruments'. These conceptual notions and ideas became important supporting elements in the IASC's international network.

At the staff level, the project was unique, as it was jointly undertaken with the Accounting Standards Committee of the Canadian Institute of Chartered Accountants (CICA). At a meeting in late June 1988 in Toronto, the IASC and the CICA came to agree that Canada would provide the necessary staff support for the project. It was also agreed that the material that was to be presented to the IASC Board would shortly afterwards be presented for approval to CICA's Accounting Standards Committee. The project was seen as enabling Canada to develop innovative guidance that was close to but distinct from U.S. GAAP:

---

[79] Interview T, October 1998.

[80] The early IASC financial instruments project pre-dated the establishment of the G4 group of accounting standard setters (Street and Shaughnessy 1998). However, the G4 became an important forum for the debate following E40. See chapter six.

The Canadians were very keen on not getting too much out of line from FASB, while looking at their own standards and what they think is best. But that sort of wanting an international solution but also not wanting it far from FASB would be close to the Canadians heart. ... I'd say it was probably self-selection. They offered. IASC was keen to accept, staff-wise was keen to accept. ... There was certainly some discussion at some stage, a number of us were certainly conscious of making sure that the international objectives didn't become problems. ... I mean it actually went remarkably well to be honest. But it didn't sort of ... there wasn't huge problems and I think that's tribute it to the skill of some of the Canadian people involved. But I think the impression was that ... it got harder as time went on for them to keep everything in sync. Once the exposure draft had been out they had more resistance in Canada than the IASC might have had internationally, for the obvious reasons that the Canadians were going to have to implement it.[81]

A tentative time schedule, which was agreed during the first meeting between the CICA and the IASC, envisioned three steps for the project: Draft Statement of Principles (DSOP) in December 1989, Exposure Draft in December 1990, and a Final Standard by December 1991. Very soon, this schedule proved to be far too ambitious. It took until November 1990 before the IASC Board was able to even approve the DSOP. A number of reasons were seen to be responsible for this delay. Less serious complication arose from the physical distance between staff in Toronto, where John Carchrae of CICA came to do most of the drafting, the IASC in London and the chairmen in Chicago and later in New York. Drafts had to be sent back and forth by courier and fax for comments to the Steering Committee, to the Consultative Group, to the IASC Board and to the IASC's around hundred member bodies. The IASC Board met only twice annually during that period and the project was scheduled around those meetings (see table 3.1). Meanwhile, a more important reason for the subsequent delay became the intellectual and conceptual challenges involved in shifting fundamental notions of appropriateness.

Capturing financial instruments

But two decisions were made very early on in the project. One was that the project would deal with financial instruments broadly, generally. It wasn't going to distinguish between derivatives and conventional things. It's going to deal with everything. The argument there was that, you know if you start trying to draw boundaries, you get conflicting accounting results and that. So we had a very broad project, which dealt with everything from cash to any sort of derivative and doing that for assets and liabilities. ... The other decision was to say we're going to deal with all enterprises, all, not just banks, but it is going right across the board. So we got a

[81] Interview T, October 1998.

comprehensive project, comprehensive coverage.[82]

A main challenge to accounting was seen to be that, by default, off-balance sheet items were not captured by financial reporting. Representing risks of financial instruments, accounting would need to draw on appropriate classifications making these instruments amenable to disclosure, recognition and measurement guidance. After adopting FASB's broad definition of 'financial instruments', the negotiations evolved around the appropriate scope of the project: First, should the project cover all financial instruments, or just derivatives - the so-called 'new financial instruments'? Second, should a standard on financial instruments be applicable to all companies, or only to banks?

The statement by the IASC representative at the OECD symposium suggested comprehensive scope. However, throughout the early discussions different notions of appropriate scope prevailed even at the staff level. The first meeting between staff and the Chairman of the Steering Committee took place in September 1988 at Arthur Andersen headquarters in Chicago. During this and subsequent meetings notions of appropriateness converged towards a more comprehensive approach. Initially, however, the CICA staff had favored standards for off-balance sheet and derivative instruments only, as was outlined in an internal concept paper:

> ... the first issue to be addressed is how to define the term "financial instrument". Once this has been done, the next issue to be resolved is whether the project should deal with all financial instruments or whether it should deal only with a sub-set of the total population. In many cases, there are already well established accounting measurement and disclosure standards for the more traditional financial instruments, such as cash, receivables, payables, equity investments, etc. Thus, the need for guidance is greatest with respect to derivative financial instruments and it is on this area that the project should focus.[83]

In contrast, Wyatt's position was characterized by an attempt to develop general accounting guidance for all kinds of financial instruments, as he highlighted in his response to the proposal by the Canadian Accounting Standards Committee:

---

[82] Interview N, August 1998.

[83] Project proposal approved by the Accounting Standards Committee of CICA on 7 September 1988, Appendix A, p. 1.

> After reading through your revised proposal more carefully, I find that your approach and what I have in mind really have only one significant difference. That pertains to your focus on "derivative" financial instruments, while my focus is broader to encompass the full set of financial instruments. No doubt I am influenced by two considerations: first, the potential difficulty in differentiating between derivative instruments and those that are more fundamental or traditional; second, the influence of the FASB approach that is, in part at least, affected by the desire of some at the FASB to use the financial instruments project as an opportunity to reconsider FASB Statements 77 and 76 on sale of receivables with recourse and in substance defeasances.[84]

During the first Steering Committee meeting, where these issues were debated, Wyatt pushed for comprehensive scope not only with respect to instruments, but also with respect to reporting entities. Similarly, during his time at the FASB, Wyatt had voted for comprehensive scope of reporting entities in the context of the FASB's financial instruments project.[85] These and other notions of appropriateness that were shaped by the U.S. regulatory debate thus came to impact on the IASC's project through the informal links that prevailed between the FASB and the IASC project. Prior to the Steering Committee meeting at which scope decisions were to be decided, project staff circulated a background paper, which promoted the comprehensive approach, proposing to widen the scope to *all* firms and *all* financial instruments:

> A. The project focus on financial instruments and not on financial institutions. The reasons are as follows: 1. It is difficult to draw a distinction between financial and nonfinancial institutions. The line between the two is blurring. Is the General Motors Credit Corporation a financial institution? 2. Financial instruments are being developed for nonfinancial enterprises who are becoming major players in the market place.
>
> B. The project include all financial instruments, old and new for the following reasons: 1. To avoid inconsistencies in accounting for newer and older instruments; and 2. To avoid being preconditioned by existing practices on the development of standards for the more recent and complex instruments such as swaps, futures, and options.[86]

Three papers came to serve as intellectual allies for these notions of appropriate scope: an article by Black (1975) about the workings of options markets, an article by Sprouse (1987)

---

[84] Letter Wyatt to Carchrae, 12 September 1988.

[85] The minutes of FASB Board meeting on 4 March 1987 read: "Mr. Wyatt said that an approach based on the type of entity would be inappropriate because it would result in excluding some counterparties from the disclosure and defining the entities to be excluded would be too difficult."

[86] Staff background paper for Steering Committee meeting, January 1989.

and the speech held by Cooke at the OECD conference, which had endorsed the IASC's initiative more broadly (OECD, 1988, p. 205-208). For example, the Sprouse article supported a more comprehensive approach on financial instruments in reference to 'creative accounting':

> Investment bankers and their legal and accounting advisors have proved to be remarkably creative in devising new financial arrangements that often appear to be designed, with one eye on the existing authoritative literature, to avoid recognition and measurements in the financial statements. Establishing accounting standards for each new financial transaction or instrument is woefully ineffective.[87]

For the definition of 'financial instruments' the background paper referred to the wording that FASB had proposed in its Exposure Draft on 'disclosures about financial instruments' (FASB 1987). The IASC's project adopted the 'financial instruments' agenda and core decisions on scope in reference to what happened concurrently in the U.S. project, but also in the off-balance sheet debate in the U.K. The project drew on support from other projects, embracing them as 'actors' in the network that gradually came to structure the international debate. Comprehensive scope became accepted in reference to U.S. developments, where FASB initially attempted to develop accounting guidance for selected instruments rather than developing comprehensive guidance for recognition and measurement of all financial instruments.

The notions of appropriateness of what accounting can and should represent that emerged in the closely-knit network of experts involved in the Steering Committee and the Consultative Group also received support from constituents, when the DSOP were eventually made public in November 1990.[88] Only health and life insurance firms and banks, who rejected the inclusion of all types of instruments and entities, arguing that their operations were sufficiently different from other entities to warrant special accounting treatment. Appeasing these concerns, health and life insurers, unlike banks, became excluded from the scope of the guidance on the basis of their 'unique liability profile' and existing accounting

[87] Sprouse (1987), p. 104. See Shah (1996) for an analysis of the process of 'creative compliance' that Sprouse implicitly refers to.

[88] According to a staff analysis, 32 out of 40 comment letters to IASC's Draft Statement of Principles indicated partial or complete support for including all entities in the scope of the project.

provisions.[89]

Establishing an enforceable accounting basis

Along with the debate on scope, the early accounting solutions suggested by the staff maneuvered between abstractions related to the conceptual framework and pragmatic classifications that referred to management intent in classifying, for example, investment and financing instruments. The degree to which a conceptual approach to recognition and measurement should dominate a more pragmatic approach remained contested. An emerging consensus among the experts indicated that the proposed standard should be conceptually sound enough to discourage management discretion and creative accounting. In reference to the strong U.K. debate on substance over form (ICAEW 1985; Law_Society 1986; Rutherford 1988), the project attempted to steer clear of the difficulties that the U.S. standard setter faced in attempts to deal with legal definitions of specific financial instruments. The project staff appealed to the 'economic substance of transactions rather than their specific legal form' (Carchrae 1991). Meanwhile, the project staff and Chairman suggested pursuing both a conceptual *as well as* a prescriptive approach:

> 1. Conceptual Approach - This approach would (a) identify relevant accounting concepts by referring to the IAS conceptual framework draft, (b) identify critical characteristics of accounting concepts which provide a basis to distinguish among alternatives in the areas disclosure, measurement, recognition, and (c) financial instruments would be classified according to their major characteristics, with the accounting guidance for each classification derived from the accounting concepts identified in (a).
>
> 2. Prescriptive Approach - This approach would develop a classification of financial instruments according to some criteria, e.g., as to their characteristics, their business or economic purposes, etc. Then determine the accounting for each of the classifications by referring to existing practice of other identified accounting concepts. Preparers and users of financial statements would determine the accounting for a financial instrument by its position within the classification system.[90]

Even after the Steering Committee had endorsed the scope and the appeal to a 'conceptual

---

[89] See Cairns (1999), p. 809.

[90] Background issues paper distributed for comment on 18 December 1988, pp. 30-31. The paper addressed but rejected a number of other approaches as well: 3. Risks approach, 4. Normative approach, 5. Consistency approach, 6. FASB approach, and 7. Combination of the above.

approach', between the first meeting of the Steering Committee in early 1989 and the approval of the DSOP, almost two years passed. Some of the delay came to be attributed to drafting difficulties and a revised exposure draft of FASB's disclosure standard in July (FASB 1989), which needed to be considered. The Steering Committee met a total of four times and members commented on the first draft in September 1989. In July 1990, the revised DSOP was sent out to the IASC member bodies for comment. And finally it was approved and published in November 1990.

In discussing the prescriptive approach, the staff initially kept open whether classifications should follow the type of instrument, e.g., long-term versus short-term instruments, or the intended use of the instrument, for example, hedging, speculating or investing. It was also left undecided which approach should take precedent over the other. Eventually, the DSOP came to endorse a distinction between different classes of instruments according to management intent. This rather 'prescriptive approach' was maintained in the Exposure Drafts E40 as well as in E48 and came to be criticized by some national standard setters as allowing too much management discretion. In embracing a prescriptive approach, the project came to be seen as reproducing what had emerged as problematic accounting practice in some of the developed capital market jurisdictions, particularly in the U.S. It suggested that the project had come to rely on pragmatic notions of practitioners. At the same time, focusing the project more on disclosures rather than recognition and measurement guidance was rejected.[91] As Wyatt pointed out:

> I think I would leave this aspect to the end since I view disclosure not as an effective substitute for proper accounting but as an effective supplement both for items reflected in the accounts and for items that do not meet whatever recognition criteria are developed.[92]

According to the IASC's aim for leading guidance on financial instruments, appropriate recognition and measurement came to take precedent over disclosures. However, despite

[91] This was an interesting deviation from the U.S., where disclosure guidance was developed first. Eventually, in 1994, it turned out that the IASC could not reach agreement on recognition and measurement. As a consequence, only the disclosure section of the early IASC project was turned into an accounting standard in 1995 (IAS 32). See chapter four.
[92] Letter Wyatt to Syal, 16 February 1989, p. 2.

appeals to notions of 'substance over form', the emerging guidance came to rely on management intent. The early debate, in reference to creative accounting, was characterized by concerns about the role of management intend that came to shape notions of appropriateness of recognition and derecognition criteria. FASB's statements 76 and 77 and the experience with off-balance sheet financing in the U.K. had discredited legalistic definitions of transfers and legal notions were seen to be at the heart of many creative accounting schemes, as Wyatt underlined:

> SFAS 77 permits derecognition of receivables (in practice including a wide variety of investments) transferred with recourse. In my view it has been widely abused. SFAS 76 permits derecognition of liabilities when certain types of securities have been deposited with a trustee so that all interest and principal payments on the debt can be met. The basis for this conclusion is that the debt is "in substance" defeased, defeasance being a legal notion whose legalitites are rarely met. Because early derecognition has progressed so far, I believe some rather precise criteria must evolve or it will be out of control ... [93]

The view held by Wyatt was close to the Arthur Andersen position taken in the context of the FASB's Financial Instruments Task Force, where John Stewart of Arthur Andersen was strongly involved. The inconsistent representation of securitization using the legal definition of Statement 77 and in-substance defeasance as allowed under Statement 76 were seen as the major challenge, strengthening notions of appropriateness to present the substance of transactions. In the early financial instruments project by the IASC, the 'risks and rewards approach' to recognition and derecognition became seen as an appropriate solution to separating accounting from purely legalistic definitions of ownership. Rather than looking at legal ownership, the DSOP came to argue that recognition and derecognition involved two questions. First, have the risks and rewards related to the asset or liability been transferred? And, second, can the item be measured reliably? It was argued that assumption of the risks and rewards associated with an asset made it probable that the associated economic benefits, that is, the substance, would be realized.

Although attempting to represent economic substance free of creative interpretations, the staff explicitly acknowledged that answering the proposed questions involved considerable

[93] Letter Wyatt to Syal, 16 February 1989, pp. 1-2.

professional judgment. These limitations notwithstanding, the risks and rewards approach seemed to promise an appropriate basis for accounting recognition, as one project member recalls:

> *We tried to capture the economic substance. Options were one way of doing that, for instance. People would grant an option to the transferor to buy the thing back and an option to the transferee to put it back. Well if those were at the same price then you knew that it was always going to go back.*[94]

When the DSOP was endorsed by the Board in November 1990, the detailed recognition and derecognition issues had not been fully resolved. Even after agreeing on a risks and rewards approach in principle, the actual drafting of guidance for what became E40 still posed considerable difficulties. Reliance on risks and rewards promised an appropriate solution to legalistic interpretations of accounting guidance. However, the project team grappled with codifying a substance over form principle that would not be prone to creative interpretations itself. A former member of the IASC recalls the difficulties at the Board meeting that endorsed the Statement of Principles:

> *And you know, clearly we were up against companies, banks wanting to take things off the balance sheet, whereas, you know, our concern was that financial instruments are left on the balance sheet. So derecognition, taking things off the balance sheet was troublesome right the way through. In fact, it still is.*[95]

For example, derecognition involved assessment of qualitative degrees of risks that were open to interpretation. Lacking neutral risk measures, it was attempted to provide guidance about transfer of risks and rewards in reference to notions like 'more or less risks' and 'substantially all risks.' Given the ambiguity of these definitions, there remained considerable resistance about adoption of this approach. Rather than limiting it, they were seen to encourage creativity. Furthermore, some members of the Steering Committee suggested that risk-based criteria were playing into a form over substance imbalance, as a staff note reporting to the Board on the concerns of the Steering Committee illustrated:

> ... in a typical securitisation of financial assets the transferor frequently retains a

[94] Interview P, August 1998. This solution to the problem of derecognition was different to the FASB approach that was modeled on legal contracts.
[95] Interview N, August 1998.

> portion of the credit risk inherent in the assets and it is therefore unlikely the securitisation transaction would qualify to be reported as a sale. Some view this as anomalous since the maximum credit risk of the transferor would be significantly less than the face value of the securitised assets what would continue to be reported on the balance sheet of the transferor.[96]

And some commentators with experience in the application of FASB Statement 76, commented in support of retaining derecognition of liabilities in an in-substance defeasance, arguing that a prohibition would counter the substance over form principle:

> In general, the principles for derecognition are consistent with the substance over form approach adopted by the Statement. ... However, the proscription of in-substance debt defeasance appears to adopt a legal form over economic substance approach that is inconsistent with the rest of the Statement. Why is the legal release of the debtor from the primary obligation under the debt agreement considered significant to the accounting for the transaction?[97]

Despite disagreement - and under severe lobbying from the banking industry that preferred retention of in-substance defeasance - the majority in the Board finally came to support the 'risks and rewards' approach proposed in the DSOP, while in-substance defeasance was rejected. It became seen as a basis for freeing accounting from legalistic definitions of transfers, supported by notions of appropriateness to represent the economic substance rather than the form of contracts.

Casting categories for measurement

While the scope and derecognition criteria first proposed in the DSOP found support by the majority of Board representatives, the November 1990 meeting had not established consensus on measurement issues. Neither did agreed measurement guidance emerge during the one year it took to develop the first Exposure Draft E40. The most controversial question was whether assets and liabilities should continue to be reported at the amount at which they were initially measured or whether they should be restated at market value at the balance sheet date. The series of arguments in the Steering Committee about what became called fair valuing of financial instruments was recalled as follows:

---

[96] Staff note, November 1990.
[97] Letter to CICA from the Ontario Securities Commission, June 1990.

The next troublesome issue was whether or not you mark everything to market, once you got it on the balance sheet. And I think it's fair to say that ... we reasonably quickly developed a consensus whereby at least trading instruments should be marked to market. Now, the definition of that group varied at different points of the process. But things, which are held for trading purposes ... you can see it through the Statement of Principles, the E40 ... that those would be carried at market value. The question is whether other things should be carried at market value or not. There was ... throughout the project, certainly right the way up to E48, a sizable minority in favor of requiring market values for everything.[98]

Devoid of agreed notions of appropriateness, during the development of the first Exposure Draft the project team attempted to maneuver a middle ground between full fair valuing of all instruments and distinguishing among different categories. The DSOP had established a formula, which made measurement dependent on management intent. It introduced three categories: (1) instruments for hedging, (2) instruments for investing and financing and (3) trading instruments. Only trading instruments, the residual category, had to be marked-to-market. Value changes of hedging instruments had to be accrued according to the hedged position. Investing and financing instrument had to be kept at their historical value and, if a fixed maturity date was known, amortized over the remaining time to maturity using the implied historical interest rate.

Satisfying demands by a sizable minority, the Exposure Draft E40 actually came to *allow* fair valuation of all financial instruments as an alternative. But since fair valuation was not going to be mandatory, the benchmark approach came to be the proposed accounting method.[99] While fair valuation was accepted for trading instruments, opposing notions of appropriateness of fair values for other instruments remained alive among the expert group associated with the Steering Committee as well as the IASC Board. Different notions of appropriateness came to be associated with 'social and cultural' factors, but not necessarily seen as determined by them, as the following comment of a project member suggests:

But, of course, in terms of the process the thing was interesting in the sense that there may have been people on the IASC ... you may well have had individuals on the Steering Committee or on the Board who might well have felt differently from what you might have perceived as being a country view. Australia took the view of market value for everything, both in the Steering Committee and on the Board. But in the UK,

[98] Interview N, August 1998.

[99] The corresponding Canadian exposure draft, published shortly afterwards, did not even include the allowed alternative to use market values for non-trading (non-operating) financial instruments.

I think it's fair to say that Peter Stilling of the Steering Committee was very much a more traditional historical cost person. He was willing to go to market value for trading things, but not for long-term things. But in the Board meetings, the U.K. may have shown more support for market valuing. And certainly, the ASB was showing support for market valuing. ...

And, of course, the Americans are interesting as well, because ... you know, what the FASB is saying with a long-term aim should be market value ... and Art Wyatt was a very enthusiastic market valuer. He was later replaced by Ron Murray, a Coopers partner, who was much more a historical cost man. So, what is the interesting thing about the IASC in general is how people vote and whether individuals might take a different view from what might have been conceived wisdom in their countries. And sometimes it's progress and other times - what I would see as progress – and other times it's not.[100]

Shifts in the supporting network of experts thus came to be associated with shifting notions of appropriateness of accounting representations. Experts that became more closely involved in the debate promoted partly opposing notions of appropriateness. However, with experience in debating financial instruments and longer duration of the project the experts involved in the Steering Committee were seen to converge on solutions that promised broader agreement. In particular, when the project saw a change in chairmanship between the DSOP and the first Exposure Draft E40, a change from Wyatt to Murray, there was a perceived change in priorities towards more pragmatic measurement categories:

I think there was a perception within the Steering Committee that he [Ron Murray] probably had a clearer view of where he wanted to go. And was probably conscious of the time pressure of finishing. ... You know, one of this problems with the Steering Committee, if there was a problem, was always: how you make sure - like a thesis - you did a manageable job well rather than trying to do the perfect job and failing. And there was always, you know, an issue there. Besides, in a way, it got more of an issue and people got more into the topic and more expert on the topic that I think there was a growing realization that if you were to do it thoroughly it could take ages.[101]

However, E40 came to be acceptable at the Board level only because it did *not* resolve the fundamental opposing views between those that wanted everything mark-to-market and those that did not. The compromise solution was to allow both methods. Interestingly, the exposure draft did fail to elaborate on some of the intricacies of a full mark-to-market model. For instance, it did not discuss what the nature of gains and losses were that would

[100] Interview T, October 1998.
[101] Interview T, October 1998.

result from changes in the fair value of certain long-term instruments. The full impact of the fair or market value model only came to be debated at a later stage of the project. For E40, the different notions of what accounting can and should represent could not be reconciled and thus led to the submission of essentially two exposure drafts, the benchmark and the allowed alternative.

Discussion

This chapter analyzes the process by which new categories of appropriateness of accounting problems and solutions emerged within a network of people, ideas and organizations. The debate came to involve experts from accountancy, banking, regulatory agencies and private-sector standard setters such as FASB and CICA. The structure of the supporting network appears to confirm concerns that accounting regulation is driven by large accounting firms and representatives of special interest groups (U.S. Senate, 1977; Puro, 1984; Sutton, 1984; Walker & Robinson, 1993). The analysis does not suggest, however, that the process of standard setting itself came to be dominated by any of these broader interest groups. Rather, the early phase of the IASC project analyzed here suggests that the emerging accounting guidance was being worked out in a rather small network of experts that gradually came to converge on appropriate problems and solutions. In the course of the 1990s, this network of experts came to contribute not only to the IASC endeavor, but also to other financial instruments projects by different national standard setters and it contributed to inter-governmental efforts in the context of the European Union.

The considerable conceptual rethinking of accounting premises that was involved in the financial instruments project makes it difficult to understand its outcomes in simple terms of political bargaining or lobbying. What it does suggest is that the novel accounting concepts that were debated needed to be able to mobilize sufficient allies - experts, ideas and organizations - in order to give plausibility to their claims. We observed that supporting concepts were drawn from particular national regimes, in particular from the U.S. and the U.K. Supporting experts and organizations were pulled into the project on staff level and at the level of the Consultative Group. These actors became mobilized around the emerging

accounting issue 'financial instruments'. The regulatory issues that came to challenge accounting at its margins became subsumed under the issue 'accounting for financial instruments' and thus made amenable for accounting regulation. The re-labeling of 'off-balance sheet risks of banks' and 'creative accounting' as issues of 'accounting for financial instruments' opened new avenues for addressing the representation of new financial contracts and the risks they were seen to entail as an accounting problem.

By extending the potential scope of what accounting could and should represent and by including all financial instruments the IASC project came to hold a distinct position internationally. This position was supported by its close alliance with banking regulators, the profession, the Canadian standard setter and - probably even more important - the conceptual building blocks that emerged in the U.S. project. The project's success as well as its failure relied on the international network of people, organizations and concepts that the IASC was able to associate with its regulatory effort.

The specificity of the accounting issue 'financial instruments' took 'some of the brightest accountants a long time just to understand what was going on'.[102] The project faced considerable difficulties in conceptualizing the new instruments within established notions of what financial accounting could and should represent. Conflicting models of what the boundaries of accounting were and should be were seen to inform different understandings of how to delineate the scope of accounting and the role of management intent. Certain notions of appropriateness, which were seen to have different social and cultural origins, for example, the specific U.S. experience with securitization, came to support different problems and solutions. Nevertheless, the closely-knit network eventually came to converge on a conceptual agreement with respect to scope and recognition.[103] The proposed categories thus came to delineate the boundaries of accounting in new ways. They were justified on the basis that they allowed a conceptually coherent representation of the new 'reality' of financial markets in accounting terms. The emerging consensus helped to frame accounting

[102] Interview g, August 1999.
[103] See also Cheit (1990) on this point. Some interesting examples of the way members become aligned to the conceptual and technical paradigms of the standard setter are also contained in Van Riper (1994).

classifications for transactions and other contractual conditions that surfaced in the context of banks' off-balance sheet risks. This process of framing allowed that, in the course of the then still fragile project, some initially controversial scope decisions gradually became taken for granted, such as accounting recognition of *all* financial instruments. These scope decisions received support from the experience with different instruments in the context of the U.S. and the definition of financial instruments in the FASB project on disclosures.

The particular intellectual challenge of the project explains why the network of experts involved in the project soon developed a considerable degree of closure and why the newly established categories weakened contrary external notions of appropriateness. Subsequent comments and contributions were forced to correspond to the new categories such as 'financial instruments', 'financial assets and liabilities' and 'risks and rewards' to make sense in the debate, thus enforcing the categories. Right from the start, banks and insurance companies resisted to include all financial instruments and all types of companies in the project. Banks rejected the substance over legal form principle and the proposed distinction between debt and equity. They also argued that the distinction between trading activities and investing activities proposed by the documents was misguided.[104] However, while the regulatory debate was not independent from pressures by constituents, lobbying by banks was resisted largely on conceptual grounds. For instance, banks did not manage to introduce categories that would render meaning to the proposed distinction between the trading and the banking book. In contrast to banks, life insurance was initially excluded because its assumed specificity, supported by existing accounting provisions for portfolio investments.[105]

In the three years that it took the IASC to issue the Exposure Draft E40, recognition criteria focusing on the transfer of risks and rewards became broadly accepted. However, as the subsequent rejection of E40 revealed, some of the new demarcations for derecognition and

[104] These are the main points taken from the summary comment by the Canadian Bankers' Association, July 1990.

[105] Life insurance financial reporting has traditionally been closer to prudential reporting (Macve and Wild 1999). For an illustration of this argument refer to the comment letter to the Draft Statement of Principles by Imperial Life of Canada, June 1990. The exclusion of life insurance firms was weakened in later proposals though.

the degree of mark to market valuation for financial instruments were less accepted in the wider public domain. Here, the conceptual shift that had emerged within the closely-knit network structuring the regulatory debate failed to establish sufficient allies. In contrast to the exposure draft E62 seven years later - which came to have considerable similarity in its mixed approach with E40 - the IASC's project in the early 1990s was seen to lack sufficient allies to push through the project.[106] E40 might have been ahead of its time, but, as will be discussed in more detail in the next chapter, it lacked intellectual and institutional support for its provisions on derecognition and subsequent measurement.

To look at the IASC's early financial instruments project less in terms of political bargaining and capturing by dominant interest groups and more in terms of emerging notions of appropriateness of problems and solutions highlights its subtle reliance on a network of concepts, ideas and supporting institutions. Regulatory debates in accounting can be seen to shape and reshape notions of appropriateness of problems and solutions, notions about how to account for entities. But they require support by a network of experts, particular regulatory experiences and ideals. As we will come to discuss further below, the meaning given to accounting that supports particular notions of appropriateness often remains stable, self-referential and operationally closed. Debates become functionally closed to the extent that meaning refers to meaning: interpretations of what is appropriate come to rely on previous interpretations thus resulting in forms of institutional thinking (Young 1996). As the case of financial instruments illustrates, *changes* in the meaning given to accounting were not established by singular and isolated floating ideas but by assemblies of mutually reinforcing claims, often involving different standard setters. As in science, where ideas and explanations can be seen to rely on allies (Latour 1987), the newly introduced concepts in international accounting regulation came to rely on supporting allies. Rather than relying on political pressures, supporting allies came to establish more persistent changes in notions of appropriateness of accounting guidance and thus in the meaning given to accounting.

[106] When E62 was due for approval in 1998, FASB had issued its broader recognition and measurement standard, FAS 133 - Accounting for Derivatives Instruments and Hedging Activities. Although there was an issue of U.S. dominance, FAS 133 came to be seen as providing intellectual support for the standard that became issued as IAS 39 in early 1999.

CHAPTER FOUR:

Constructing accounting representations of financial risk

Constructing accounting representations of financial risk

Abstract

The IASC's project on financial instruments and corresponding accounting regulation in the U.S. emerged in the international context of longer lasting and still ongoing attempts to represent the contingent effects of *future events* in accounting. Rather than considering risk disclosures, this chapter focuses on the changes in *recognition and measurement* guidance that took place during the late 1980s and 1990s. The international regulatory debate on recognition and measurement guidance of financial instruments came to be immersed with conflicting notions of appropriateness concerning the representation of financial risks. As much as it dealt with technical intricacies, the debate concerned wider claims of accounting for representation of financial risk and the resistance to these claims. Three interrelated aspects of the changing guidance on recognition and measurement of financial instruments are discussed in this chapter. The first aspect concerns the separation of recognition and measurement guidance. The second aspect involves the attempt to limit discretion in recognizing financial instruments. The third aspect relates to expanding the scope for professional judgment in measurement guidance by appealing to the notion of fair values. The respective notions of appropriateness emerging in the regulatory debate remained contested as the resistance of banks illustrates. Underlying the apparently technical disagreement about valuation techniques seemed to reside claims and counterclaims to applying expert knowledge to representing financial risks.

Introduction

During the late 1980s and early 1990s, when national standard setters took up financial instruments projects, they usually commenced with risk disclosures in the notes to the accounts, following the U.S. example. Meanwhile, draft guidance under the comprehensive IASC project also aimed to address recognition and measurement of financial instruments.

This involved shifting the assumptions about which financial risks may appropriately be represented by accounting. Although much of the regulatory debate was framed as a debate about the appropriate representation of *performance* and *position* of an entity, this chapter suggests that it became even more so a debate about the appropriate representation of *financial risk*. Focusing on the IASC's project in its close relationship with relevant U.S. and U.K. guidance, this chapter discusses the regulatory concern with representation of financial risks within the constraints of accounting statements, rather than in the notes.

As mentioned in chapter three, the early financial instruments project of the IASC came to embrace rather comprehensive scope: it was to include *all* financial instruments and virtually *all* types of reporting entities, except life insurance firms. It was the notion of *financial instruments* that was seen to allow shifting the boundary of what accounting can and should represent to include formerly off-balance-sheet items. Once these instruments were included in the scope of the financial instruments project, their representation was seen to be a simple matter of developing appropriate recognition and measurement criteria. Developing appropriate recognition and measurement criteria, however, proved to be more difficult than expected. This chapter looks closer at the shifts in recognition and measurement criteria before and during the IASC project on financial instruments. It looks at how these shifts related to notions of appropriateness regarding the representation of financial risk in accounting. It does so in reference to a more general sociological theory of risk proposed by Luhmann (1993). Rather than understanding risk in terms of specific measurement technologies, Luhmann suggests considering different notions of risk with respect to the way they attribute contingencies across time. In contrast to fate, danger or uncertainty, notions of risk presume a decision or action that can be associated with expected outcomes of future contingent events. In other words, risk is a social construction that associates outcomes of an expected future event with prior action, whereby the future event is seen to be contingent on the prior action. We may contrast specific meanings of risk by looking at the way past and future events are being associated and by the way, contingent gains or losses come to be seen as the result of a decision or other action.[107]

[107] To give an example, in his Reith Lectures 1999, Giddens talks about a distinction between external

As argued in chapter three, the emerging projects on financial instruments became seen as a response to concerns about the representation of financial risks in financial statements. The regulatory debate became immersed with a concern of how to reflect the contingencies associated with future events that were seen to affect expected cash flows of financial contracts. At the same time, corresponding to fast moving financial markets, new conceptualizations of financial risks in financial management were seen to emerge as responses to failures of earlier conceptualizations of risk:

> Many advancements [in risk measurement] were driven by unfortunate experiences, in particular that a previous measure reported risk to be within limits when losses indicated otherwise.[108]

This 'journey' of advancements in the conceptualization of financial risks for financial management came to involve more sophisticated instruments such as caps and collars and collateralized mortgage obligations. Risk management that was seen to emerge with a focus on credit limits and duration equivalents came to comprise stress testing of portfolios and value at risk measures by the mid-1990s. In financial accounting the historical cost model and traditional recognition and measurement practices, relying on provisions and similar accounting reserves, implicitly constructed financial risks by selectively considering the perceived downside of asset values. Recognition in accordance with the conceptual framework projects had come to rely on the selective estimation of future risks and rewards associated with an item. This, however, was seen to allow management discretion in recognizing items. The arduous debate about appropriate recognition criteria for financial instruments grappled with constructing risks and rewards associated with instruments in terms of less ambiguous quantification in money terms. Two aspects of the proposed accounting guidance came to change in the course of the financial instruments project: aspects of measurement became separated from recognition criteria and recognition came to rely on contractual terms. These changes had severe repercussions for measurement

---

risks and manufactured risks. This distinction draws on the way consequences are associated with identifiable human activities: "At a certain point, however, - very recently in historical terms - we started worrying less about what nature can do to us, and more about what we have done to nature. This marks the transition from the predominance of external risk to that of manufactured risk." Source: http://www.lse.ac.uk/Giddens/reith_99/week2/lecture2.htm

[108] Beder (1997), p. 349.

guidance, as all financial instruments had to be recognized, some of which had not been reliably measurable by the subjective standards of management - otherwise they would have been recognized before. In a parallel development, measurement guidance came to rely on the notion of *fair value* as a general model for measuring all financial instruments. Although the techniques on how to establish fair value initially remained unspecified, fair valuation of all financial instruments soon became a serious option for financial accounting, in particular as fair valuation was seen to allow explicit consideration of risks associated with financial instruments.

All these shifts in proposed recognition and measurement guidance not only came as a defense of established accounting claims to representing financial contracts. They gradually came to be seen as allowing accounting to enter hitherto uncharted territory of representing financial risks in a systematic way. Although the aspects of recognition and measurement were related, the political controversy stirred by the financial instruments project focused mainly to the aspect of fair value measurement. The strongest resistance came from commercial bankers. Many arguments by bankers against the use of fair value appealed to 'economic consequences', suggesting that the proposed use of fair values would affect the way banks were operating. However, an important aspect seemed to be the accounting claim to representing financial risk that was traditionally seen to be the domain of banks. Banks, who considered themselves the traditional bearers and intermediaries of financial risks, were fiercely challenging the accounting claim for representation in this area.

The remainder of this chapter comprises four sections and a discussion. The next section focuses on the separation of recognition and measurement resulting from the failed attempt to establish a 'risks and rewards' approach for recognition and derecognition of financial instruments. The next section looks at how recognition guidance came to rely on the notion of contractual control instead. The subsequent section discusses the emergence of the notion of fair value as a general valuation model for measuring financial instruments. The fourth section considers the resistance of banks to the proposed changes. The chapter closes with a brief summary and discussion of the chapter's findings.

Assessing risks and rewards

By the time accounting regulation came to face off-balance sheet risks associated with financial instruments in the mid-1980s, some authoritative guidance on representing the contingency of future events had been firmly established. Financial reporting reflected the contingency of future events, among others, by provisioning and by the way it required items to be classified on the balance sheet. For instance, provisions for receivables were seen as a means to reflect the likely future loss associated with insolvency of debtors. Likewise, the classification between long-term and short-term assets and liabilities was seen to match future in- and outflows within a one-year horizon. This guidance relied on notions of prudence thus rendering accounting representations asymmetric. It also relied on preparers' judgment. During the 1970s, accounting practices that depended on management's assessment of future events became seen as a source for 'creative accounting' and there were increasing pressures to limit the scope for management discretion. Various attempts to make the recognition criteria more reliable emerged in the decade before projects on financial instruments came to be considered. Rather than relying on preparers' asserted beliefs about future cash in- and outflows, accounting guidance for recognition and derecognition came to aspire to representing the economic substance of transactions in reference to reliably measurable future risks and rewards.

Reliance on control

The case of the U.S. provides a good example for early attempts to account for future events preceding its financial instrument projects, which is worth reviewing, as the IASC's later financial instruments project became influenced by this U.S. guidance. Some of the first FASB standards that addressed how future events could and should be considered in accounting emerged during the 1970s in the context of provisions for expected losses (Burton 1993). In the respective project, the newly established FASB came to identify those types of expected *future events* that could serve as a trigger for accounting recognition of losses. The result was SFAS 5 'Accounting for Contingencies', issued in 1975, that came to amend Accounting Research Bulletin (ARB) No 43. It suggested analyzing contingent future

events into three categories:

a. *Probable*. The future event or events are likely to occur.

b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

c. *Remote*. The chance of the future event or events occurring is slight.[109]

These rather vague categories were illustrated in reference to specific examples of possible loss contingencies. To be able to provide for contingencies paragraph eight of SFAS 5 set two conditions. It needed to be *probable* that a future event would confirm that an asset had been impaired or that a liability had been incurred. Further, the amount of loss had to be *reasonably* estimated, that is, measured. If these conditions were not met, only disclosures would be allowed. In justifying this guidance, the committee referred to the convention of conservatism. It concluded that the mere existence of risk would not be enough - it needed to be *probable* and *measurable* as well.

The reference to probable and measurable future events codified in SFAS 5 came to affect later guidance considering the transfer of risk. It came to influence the debate on financial instruments not only for the FASB, but also for the IASC as it suggested explicit consideration of risks as well as rewards. More specifically, SFAS 5 came to influence the debate on financial instruments through its impact on the guidance in SFAS 76 'Extinguishment of Debt', which was issued in November 1983. Apart from straightforward extinguishing of debt by repaying interest and principal, SFAS 76 considered two other ways to extinguish and derecognize debt. One way was to release the debtor from the primary debt obligation. The other way involved what was then legally known as in-substance defeasance.[110]

---

[109] SFAS 5, par. 3 (original emphasis).

[110] SFAS 76, par. 3, describes these two alternatives as follows (original emphasis): "... (b) The debtor is legally released [FN: If nonrecourse debt ... is assumed by a third party ... the sale and related assumption effectively accomplish a legal release ...] from being the primary obligor under the debt either judicially or by the creditor and it is probable [FN: *Probable* is used here, consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that it is likely that no payments will be required.] that the debtor will not be required to make future payments with respect to that debt under any guarantees."

"(c) The debtor irrevocably places cash or other assets [par. 4: ... monetary assets that are *essentially*

In particular releasing the debtor from the primary debt obligation was made dependent on *probable* future payments in explicit reference to the definition in SFAS 5. In-substance defeasance, in conjunction with the definition of monetary assets, set out in subsequent paragraphs, referred to e*ssentially risk free* claims that an entity could use to meet its liability. Risk-free claims were specified as claims that were firmly known with respect to amount and timing: claims 'to receive a sum of money that is fixed and determinable without reference to future prices of specific goods or services'.[111] Both provisions were seen to conform with the conceptual framework notions of derecognition and liability.[112] However, as was argued by critics, even if a third party assumed the debt, an entity remained exposed to at least *some* financial risk. Risk thus remained constructed in accounting in a way that associated contracts with *selective* effects of contingent future events. Retention of some risk in the case of derecognition of debt was mirroring the case in which a company retained some risk after a sale of an assets with recourse to the seller. Debates on financial instruments later took up this issue when discussing derecognition of financial assets or liabilities under circumstances where at least some risk was retained like in a securitization. Because of the selectivity involved in constructing risk, considering the transfer of risks and rewards for recognition and derecognition involved a difficult judgment about degrees of risk. In the further course of the regulatory debate, this became seen more broadly as a *problem* of relying on management intent.

With SFAS 77 'Reporting by Transferors for Transfers of Receivables with Recourse', issued in December 1983, the FASB was seen to cover new ground. Although it was also seen to give in to the securitization industry, which relied on the selectivity of risk construction mentioned above, this new approach first suggested abandoning the risks and rewards approach that was underlying SFAS 76. Instead, it came to rely on the notion of control. SFAS 77 allowed the derecognition of receivables under the following conditions:

a. *The transferor surrenders control of the future economic benefits embodied in the*

---

risk free ...] in a trust to be used solely for satisfying scheduled payments ... and the possibility that the debtor will be required to make future payments with respect to that debt is remote. ..."

[111] SFAS 76, par. 4, footnote 3.

[112] See, for example, the 'Basis for Conclusions' in par. 18 of SFAS 76.

receivables. ...

b. *The transferor's obligation under the recourse provisions can be reasonably estimated. ...*

c. *The transferee cannot require the transferor to repurchase the receivable except pursuant to the recourse provisions. ...*[113]

Loss of control was defined in reference to whether the reporting entity would retain its rights and obligations in a bankruptcy situation. Previous guidance, including SFAS 76, had considered the constructed risks and rewards on part of the transferor only. With the mushrooming of new financial contracts that juggled with attributions of rights and obligations between partners, this was seen to create holes in accounting. Without considering the position of the transferee, it could, for example, become possible that instruments were derecognized by one entity without being recognized by another entity. What was new about the guidance in SFAS 77 was that it required looking at both, the transferee as well as the transferor. It was seen to allow closing 'holes' resulting from the selectivity in the discretionary construction of risk, as the financial instrument needed to be recognized by the party that controlled the risks and rewards associated with assets and liabilities. However, this involved the scenario of a bankruptcy situation, as one close observer put it, who was also involved in the IASC project. Rather than considering transfers of selectively constructed risks and rewards...

... the Americans ... said: 'what has the transferee got? Could the assets be taken back from the transferee at less than their market value at the time?' In which case the transferor still has control. And they even go so far as to say: 'could ... the receiver in bankruptcy of the transferor get them back?[114]

The notion of control introduced in SFAS 77 was developed further in SFAS 125 'Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities', issued in 1996. SFAS 125 was a broader attempt to reconcile the contradictions that had arisen in the mid-1980s from competing approaches to recognition and derecognition - risk and rewards versus control of assets and liabilities. In working towards

[113] SFAS 77, par. 5, original emphasis.
[114] Interview P, August 1998.

SFAS 125, the FASB attempted to further improve and broaden the application of the control approach to recognition and derecognition. In relying on control, the FASB was seen to *separate* the recognition guidance from management's assessment of the repercussions of future events. It was thus seen to limit the impact of idiosyncratic constructions of risk that had haunted guidance on recognition before. However, other standard setters did not appreciate the reliance on control:

> *Now we do have some difficulty with that because it seems to us that by the time you are talking about the receiver in bankruptcy you no longer have a set of going concern accounts for the transferor. So to put into the transferor's going concern accounts assets that he can only control when he has gone bust is a bit like telling a man that because there is an insurance policy that will pay out a million pounds on his death he's a rich man. He isn't.* [115]

Fundamental risks

Instead of following the direction taken by the FASB with its control approach, other national standard setters and the IASC project kept relying on the risks and rewards entailed in contracts. Rather than separating management's construction of risk from recognition guidance, it was felt to be appropriate to make the criteria for risk assessment firmer. By the late 1980s, the conceptual framework projects were seen to support this aim. Within conceptual frameworks, reference to risk and rewards tended to be either implied in the definition of assets and liabilities, as in the case of the FASB's conceptual framework,[116] or codified in recognition criteria, as in the case of the IASC:

> 89. An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.
>
> ...

[115] Interview P, August 1998.

[116] For example, CON 6 (FASB 1985a), par. 25: "Assets are probable [FN: *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary of the American Language* ...). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (...)] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (original emphasis)

> 91. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. ...[117]

The IASC's Framework referred to probable future in- or outflows of benefits for *recognition* guidance. It also required *reliable measurement* of these benefits. However, in the case of financial instruments lack of reliable measurement was seen as one of the reasons why many contracts were not recognized and thus remained off-balance sheet. Furthermore, as the experience of FASB with the risk and rewards approach suggested, reliance on qualitative and subjective assessment of outcomes of future events made accounting classifications subject to management discretion. As part of the IASC's financial instruments project, it was therefore hoped to establish *firmer* guidance on how to construct financial risks and criteria for recognizing commitments to risks and rewards. In one of their first drafts, the IASC's project team started out with the following:

> Principle # 1 - Two specific criteria must be satisfied before rights and obligations can be recognized as financial assets and liabilities: (a) transfer or creation of exposure to risk and (b) "firmness" of commitment. ...[118]

Commentators challenged this principle on the basis that the requirement for firmness would not allow accounting guidance to be viable. Some comments received on this proposal contrasted the aspect of firmness with the conceptual framework guidance on recognition. For example, the representative of the Australian body AARF commented:

> I would prefer to see the framework recognition criteria as the focus for this section... In any event, I believe that when an entity has control over the future economic benefits from holding the asset it has assumed the risks and rewards associated with the asset. ... Retention of the framework recognition criteria would avoid the need to define when an instrument is a firm commitment.[119]

This suggested adopting more wholeheartedly the risk and rewards approach implied in the IASC's Framework, requiring recognition of an instrument when it was probable that future economic benefit will flow to or from the enterprise and the cost or value of the instrument

---

[117] IASC Framework for the Preparation and Presentation of Financial Statements, published in July 1989.
[118] Draft Statement of Principles, July 1989, par. 30.
[119] Letter by the Technical Director of the AARF to John Carchrae, 4 October 1989.

could be measured with reliability. Notwithstanding the concern that these requirements allowed management discretion, the subsequent draft, one year later, proposed recognition criteria closer to the conceptual framework. 'Firmness' was replaced by consideration of reliable measurement:

> A financial instrument should be recognised in the balance sheet when: (a) the risks and rewards associated with the asset have been transferred to the reporting enterprise; and (b) the cost or value of the asset to the reporting enterprise can be measured reliably.[120]

While this seemed to be almost full circle back to from where the project had started, the IASC additionally attempted to operationalize the notion of reliable measurement thus making the recognition criteria less ambiguous. Operationalizing reliable measurement and casting what was seen as idiosyncratic constructions of financial risk into firm guidance, however, became a rather intricate task. Attempting to associate the substance of contracts with contingent outcomes of future events, the IASC project came to refer to categories of financial instruments that were developed in the work leading to the Basle rules. As mentioned in chapter three, the Basle work associated credit risk - which was considered as a proxy for other financial risks as well - with particular instruments. The approach distinguished between primary and secondary risk. Risk transfer was seen to take place with the transfer of primary or secondary components of risk:

> Principle # 2 - In considering the importance of risks more weight should be given to primary risks. ... Every financial instrument subjects the enterprise to one or more of these risks. Usually one or more risks will predominate. These risks can be subdivided into: - Primary risk - that is, the risk that is most significant in amount and that has the greatest probability of leading to a gain or loss for an enterprise. - Secondary risk - that is, the risk that is not as significant as primary risk.[121]

A simple table (see figure 4.1) was meant to allow ready reckoning of these primary and secondary risks of some of the major financial instruments. It associated risks with instruments on the basis that there were clearly identifiable primary and secondary types of risk. The table that the IASC project provided was far simpler than a similar table contained in FASB's draft on risk disclosures (FASB 1989).

[120] Draft Statement of Principles, June 1990, principle 4.
[121] Draft Statement of Principles, July 1989, pars. 33-35.

Figure 4.1: Associating instruments with financial risks

IASC Steering Committee on Financial Instruments — DRAFT FOR COMMENT BY JUNE 15, 1990

APPENDIX A

RISK MATRIX FOR SELECTED CREDIT AND DERIVATIVE FINANCIAL INSTRUMENTS

	Credit Risk	Price Risk: Foreign Exchange	Price Risk: Interest Rate	Price Risk: Market	Liquidity Risk	Underlying Instrument
Loan commitments	X	•	•		x	Loans
Letters of credit	X	•	•		x	Loans
Note issuance facilities	X	•	•		x	Loans
Revolving underwriting facilities	X	•	•		x	Loans
Options						
Bought: Foreign exchange	x	X				Currency
Interest rate	x		X			T bills
Stock	x			X		Stocks
Sold: Foreign exchange		X				Currency
Interest rate			X			T bills
Stock				X		Stocks
Futures						
Foreign exchange	x	X			x	Currency
Interest rate	x		X		x	T bills
Stock index	x			X	x	Stocks
Forwards						
Foreign exchange	x	X			x	Currency
Interest rate (FRA)	x		X		x	T bills
Swaps						
Interest rate	x		X			Money mkt. instrument
Cross-currency	x	X	x			Currency
Caps, Collars and Floors	x		X		x	Loans

X Indicates primary risk.
x Indicates secondary risk.
• Risk may be present depending upon terms of transaction.

JAC/HD/IASCMarch 1-3/90 — March 14, 1990

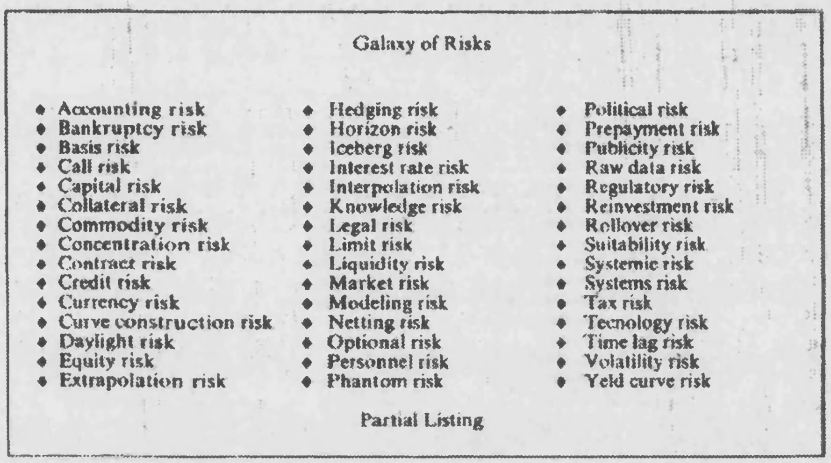
Not for release to the public or the press

As further discussions suggested, however, lists of components of risks of financial instruments had to remain incomplete. New instruments emerged. With more liquid and deep markets certain risks like liquidity risk, but also credit risk, were seen to become less important. Some commentators felt that the 'risk and rewards of financial instruments are so varied, and will continue to be so in the future, that it is impractical to try to provide very specific guidance'.[122] This seemed to be confirmed by the conceptualization of risks undertaken by consulting firms specializing on risks. For example, in 1987, Capital Market Risk Advisors Inc., a consulting firm, started monitoring the basic financial risks (Beder

[122] Comment letter by International Association of Accountants, 13 June 1990.

1997). Almost ten years later, credit risk, which was seen as the culprit of financial market losses prior to the 1980s, had become surrounded by a host of other risks, as summarized in figure 4.2.

Figure 4.2: The emerging galaxy of financial risks[123]



Source: Capital Market Risk Advisors, Inc.

Fundamental instruments

A more analytical approach to breaking down the guidance on identifying and measuring elements of financial risk was briefly discussed in the U.S. project on financial instruments during the late 1980s. To refine the mapping of components of risk with instruments, this attempt suggested associating the risks of basic *components of instruments* rather than constructing notions of risk in relation to financial instruments as a whole. This became known as the 'Fundamental Financial Instruments Approach' (Bullen et al. 1989; Casson 1998). It was based on the premise that financial instruments consisted of a few fundamental building blocks, so-called 'fundamental financial instruments'. Determining how to recognize and measure these fundamental components was seen as the first step to resolving the accounting issues raised by more complex financial instruments. The FASB staff tentatively suggested identifying fundamental instruments by considering the future transactions, or exchanges, that were associated with items:

> [A] financial instrument that entails a right or obligation to exchange looks to a

[123] Beder (1997), p. 347.

> further transaction that will, if it occurs, consist of a two-way flow of cash and other financial instruments - an exchange. Whether a contract to exchange gives rise to an asset, a liability or perhaps both is determined by the potential for a favorable or unfavorable result.[124]

To identify these fundamental instruments, the FASB staff suggested looking at the characteristics of different basic financial instruments. *Payables* or *receivables* were seen as straightforward rights or obligations to one-way cash flows: their contractual terms involved that one party transferred cash to another party in the future. In contrast, rights or obligations associated with *derivative* instruments were typically seen to involve two-way flows: the holder of the right or obligation would both give and receive cash flows in the future. Furthermore, it was argued that transactions could be distinguished based on whether or not they were contingent on future events and whether or not these events were controlled by one of the contracting parties.

These characteristics were seen to suggest six types of fundamental financial instruments: (1) unconditional receivables *or* payables; (2) conditional receivables *or* payables, dependent on the occurrence of an event beyond the control of either party; (3) forward contracts, entailing unconditional rights *and* obligations; (4) options, as conditional rights *or* obligations within control of one party; (5) guarantees or other conditional exchanges entailing conditional right *or* obligation beyond the control of either party; (6) equity instruments as rights or obligations in the case of the entity's liquidation.

The fundamental financial instruments approach suggested classifying financial instruments by the types of rights and obligations regarding future cash which they established. It was seen to allow associating the instruments with the types of financial risk to which they were exposed. However, the six types mentioned above and any further attempt to refine this approach remained inconsistent. For example the distinction between a right to cash flows and a derivative, as a 'right to a right to cash flows', while reflecting a pragmatic categorization, was not sustainable analytically. The way financial instrument came to be defined in the late 1980s suggested that rights or obligations to receive or deliver cash were,

[124] Bullen et al. (1989), page 72.

in their economic substance, not much different to derivative rights or obligations concerning these underlying rights. Ultimately, they were also rights and obligations to receive cash, as the definition of financial instruments by the FASB suggested. The distinction between contracts that were conditional and those that were unconditional on future events were similarly unsustainable. The practice of provisions for doubtful debt exemplified that most 'unconditional' rights to cash flows were eventually construed as risky, as dependent on some future state of the world that could adversely affect a debtor's ability or willingness to pay. Rather than being a discrete characteristic of certain components of instruments, risk seemed to be more gradual and all pervading.

Notwithstanding its analytical incoherence, there was some initial enthusiasm for the fundamental financial instruments approach. It was seen to limit the discretion of management in determining financial risk associated with financial instruments. It even received support from academic quarters, defending it against the criticism to lack analytical rigor:

> Mr. Bierman then commented that the premise of fundamental instruments should hold up, saying that "the fact that you can replicate [a fundamental instrument] doesn't make an instrument not a fundamental. It just means you've got to be careful about how you define the instrument. What we're looking at here is the underlying economic concept - the underlying economic implication."[125]

However, the debate soon turned against the analytical construction of risky components of financial instruments. It was argued that the approach created unnecessary complications in areas where accounting for a financial instrument was seen to be unproblematic. Under the fundamental financial instruments approach, a straightforward government bond would need to be broken down into a number of separate cash flows. As each cash flow was seen to represent a separate fundamental financial instrument, it would need to be accounted for separately. John Stewart, an Arthur Andersen partner and member of the FASB's Task Force on Financial Instruments, argued that 'no one is concerned about accounting for the 18 various pieces' of a government bond, and the minutes of the respective Task Force

[125] Final Minutes of 22 May FASB Task Force Meeting on Financial Instruments, dated 1 August 1989.

meeting stated:

> Mr. Stewart's example illustrated what he said is the main problem with the FFI [fundamental financial instruments] approach: "The approach doesn't get to the real [accounting] issues ... It appears to 'solve' problems that aren't problems."[126]

While it was seen to 'solve' problems that were not problems, the fundamental financial instruments approach became seen as inappropriate to fulfil the ideal of non-ambiguously construing financial risk. As the increasing sophistication of financial contracts had made it difficult, if not impossible, to associate the effects of future events with specific financial instruments, the traditional classification was seen to become too broad and dependent on subjective interpretations. Establishing firmer categories for representing financial risks became seen as the appropriate problem. However, the attempt to consider the construction of risk by analytically separating contracts into fundamental cash flow components and recognizing and measuring each of the components separately was in itself seen to create more problems than it solved. The FASB's Task Force rather came to suggest to retain the comprehensive definition of financial instruments and to apply a *synthetic* rather than an analytical approach to recognition guidance. This suggested recognizing financial instruments the way they were contracted and measuring them according to the standards of the financial industry. The type of accounting guidance this might lead to was indicated by FASB's Technical Director:

> Mr Leisenring then drew the task force members' attention to ... the breadth of accounting issues up for consideration. He concluded ... by stating his opinion that if the Board is "going to solve some of these problems, we're going to have to embrace - to some degree - mark to market accounting."[127]

As attempts failed to operationalize probable and reliable measurement of future events through considering components of risk or components of financial instruments, mark to market accounting gained currency (Benston 1986; Macve and Jackson 1991). Mark to market accounting became seen as closer to the way these instruments were contracted and

[126] Final Minutes of 22 May FASB Task Force Meeting on Financial Instruments, dated 1 August 1989.
[127] Final Minutes of 22 May FASB Task Force Meeting on Financial Instruments, dated 1 August 1989.

measured in financial markets. Representing financial instruments the way they were considered and constructed by market participants suggested to *separate* recognition from measurement guidance. It suggested moving recognition guidance closer to the contract and separately measuring financial instruments at the balance sheet date.

Considering the contract

In contrast to the U.S. debate and despite growing criticism about the discretion it was seen to involve, the IASC's project continued to rely on the risk and rewards approach for recognition even in its Exposure Draft E48, which was issued in 1994. The only change in recognition criteria between E40, issued in 1991, and E48 concerned adding the qualification 'substantially all' as well as the consideration of components of financial instruments when distinguishing between debt and equity (Barth et al. 1998). Meanwhile, during the mid-1990s, there was a gradual shift towards reconsidering the contract as the point of recognition as can be seen from table 4.1.

Table 4.1: Criteria for recognition and derecognition[128]

Document	Recognition	Derecognition
IASC Exposure Draft E40 (1991)	Reliably measurability of risks and rewards	Transfer of risks and rewards
IASC Exposure Draft E48 (1994)	Reliably measurability of substantially all risks and rewards	Transfer of substantially all risks and rewards of components
ASB FRS 5 (1994)	Measurability of assets and liabilities	Transfer of significant rights and obligations with linked presentation
FASB SFAS 125 (1996)	Control of assets and liabilities	Transfer of control
IASC Discussion Paper (1997)	Party to contract involving financial instrument	Transfer of control
IASC Exposure Draft E62 (1998)	Party to contract involving financial instrument	Transfer of control

Recursive deadlock

While the IASC's comprehensive financial instruments project continued to rely on measurable risks and rewards, recognition guidance for financial instruments in the U.S. came to embrace the control approach first introduced in SFAS 77 and further developed in

[128] A more detailed table including full references is contained in appendix A4, table A4.1.

SFAS 125. In the U.K., financial instruments were addressed in the early 1990s, when the ASB refined the ASC's attempts to get to grips with off-balance sheet financing.[129] The specific U.K. answer to derecognition under a securitization arrangement was to recognize both assets and liabilities in a so-called linked presentation on the face of the balance sheet applying a simple test for economic substance. ASB's Financial Reporting Standard (FRS) 5 was seen to separate the idiosyncratic judgement about repercussions of future events, that is, management's construction of financial risk, from recognition guidance. Rather than doing so in reference to the notion of control suggested by the FASB, it called for assessing risks and rewards in reference to opportunity costs. Like the notion of control, this was seen to avoid the judgmental hermeneutics of assessing primary or secondary risk of instruments or even different types of risk. Unlike the notion of control, which was seen to focus on bankruptcy, it was seen to consider the purely commercial implications of the contract under going concern assumptions.

> *One is to look at ... to look at the commercial implications of all the conditions in a series of transacting, one transaction or a series of transactions. You may have a series of contracts or conditions and it says also pay particular attention to the conditions that are most likely to have a commercial effect in practice. That's because we found a lot of these contracts would be drawn up putting in all sorts of conditions, some of which were quite remote but tended to show that the thing was sold. Whereas, when you look carefully, you realised that there were other conditions which simply bought it back to you in almost all circumstances.*[130]

The ASB considered representing the economic substance of the commercial contracts in accounting in terms of the economic alternatives. The IASC project, meanwhile, kept on relying on construed risks and benefits for recognition in E40 and E48. Apart from the criticism that this left determining 'substantially all risks and benefits' to idiosyncratic judgment, other conceptual weaknesses were pointed out, for example by the ASB:

> Potential problems with E48's approach arise in transactions that divide the risks and

[129] ASB further developed the notion of economic substance suggested in Technical Release 603 of the ICAEW (1985). It was seen to establish a *substance over form* principle in its statement FRS 5 'Reporting the Substance of Transactions', published in 1994. Rather than referring to risks and rewards it employed the conceptual framework definitions of assets and liabilities. However, ASB's criterion for recognition in FRS 5, while relying on assets and liabilities rather than risks and rewards, still required reliable measurement of the future benefits or obligations.

[130] Interview P, 19 August 1998.

> rewards of an item between several parties such that no one has substantially all of them. Rather each party has a separate asset of its interest in the original item. The issue is particularly relevant for financial instruments that, by their nature, can be more easily divided than physical items. An example is an interest rate strip where an interest bearing debt is divided into rights to interest (that are held by one party) and rights to principal (that are held by another). In this case it would seem right for each party to recognise an asset of its rights to some of the cash flows from the underlying debt, despite not having substantially all the risks and rewards of that debt.[131]

As recognition in E48 depended on how the risks and rewards were construed by partners, it was feared to result in incomplete accounting. Unlike the IASC, the ASB (FRS 5) and the FASB (SFAS 125) had by then more firmly embraced the framework notions of assets and liabilities for recognition guidance. Because the IASC had published its conceptual framework, which was similar to the U.S. framework in this respect, commentators pointed to some contradictions. It was argued that recognition guidance for an asset or a liability could not involve those characteristics that made a contract an asset or a liability in the first place. As the FASB commented:

> We believe the recognition of financial assets and financial liabilities should be tied in with the definition of assets and liabilities in the IASC's conceptual framework, which defines assets and liabilities as resources and obligations, respectively. However, the standard for recognition in paragraph 19 appears to base recognition of financial asset or liability on the "risks and rewards associated with the asset or liability," a circular reference.[132]

To avoid any such circular reference, the FASB's definition of financial assets and liabilities had come to rely on the contractual chain of rights or obligations to future cash flows rather than considering the net effect of a contingent future. As discussed in chapter three, the definition of financial instruments comprising derivatives and other contracts on cash flows referred recursively to financial instruments. However, as the FASB had pointed out:

> The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.[133]

---

[131] Letter from ASB to IASC, 27 May 1994.
[132] Letter from FASB to IASC, 26 July 1994.
[133] SFAS 107, par. 3, footnote 2, original emphasis.

In contrast, recognition of financial instruments in reference to the notions of risks and rewards was seen as circular, as it construed a chain between a contract and a future cash flow that was already part of the definition of the financial instruments. While the notion of financial instruments comprised chaining a contract to future cash flow by a sequence of rights and obligations, it abstracted from measurement aspects concerning the cash flows and thus from any assessment of reliably measurable risks and rewards. Recognition of financial instruments and their measurement could thus be separated - at some cost to *de*recognition and measurement guidance though, as will be discussed further below.

Breaking new ground

Breaking with the tradition of both E40 and E48, which had relied on risks and rewards, the IASC's Discussion Paper, published in 1997 under the Chairmanship of Alex Milburn, came to emphasize a different trigger for recognition. It emphasized the instance of becoming party to a contract that gives rise to a financial instrument, thus releasing the guidance from considering what was seen as idiosyncratic constructs of financial risk. Reference to financial instruments substituted reference to risks and rewards associated with future events. This recognition guidance based on the contract was subsequently adopted in E62 as well as in the standard IAS 39.

While the recognition criteria proposed in the Discussion Paper released the guidance from assessing risks and rewards, the resulting simplification in recognition criteria shifted some of the judgmental burden to derecognition and measurement after initial recognition. Derecognition became increasingly complex, mainly because of attempts to accommodate the securitization industry. Eventually, the IASC came to adopt the FASB's notions for derecognition guidance that relied on transfer of *control*, though with less emphasis on bankruptcy. As mentioned above, this not only involved considering the position of the transferor but also the position of the transferee. In particular, the last condition established a benchmark based on a going concern rather than a bankruptcy assumption:

> 9.14 The Steering Committee proposes that the following principles should govern the determination of whether control over a transferred asset has been surrendered by the transferor:

(a) Control is not surrendered if the transferor can revoke the transfer and essentially put things back the way they were.

(b) For control to be surrendered the transferee should have the ability, in normal course, to realise the contractual rights that comprise the transferred financial asset. If a financial asset is transferred to a special purpose entity, then this condition would be met if the holders of the beneficial interests in that entity have this ability.

(c) Control is not transferred if the transferor is entitled or obligated to purchase or redeem the transferred assets at a fixed or determinable price that effectively provides the transferee with a rate of return that is equivalent to interest on the funds it has provided to the transferor.[134]

With the IASC Discussion Paper 1997 recognition was to be associated with becoming party to a contract. It shifted the focus from considering constructs of financial risk in terms of contingent effects of future events to considering the nature of the financial contract and whether it established a financial instrument or not. However, separating recognition and measurement in this way came to conflict with the recognition criteria suggested in the conceptual framework of the IASC, which still required assessing probable and measurable future flows of benefits. In view of this apparent contradiction with the framework, the Steering Committee responsible for the Discussion Paper argued:

> ... the IASC Framework has a different significance for financial instruments than it does for non-financial items. ... the probability of future economic benefit inflow or outflow enters into the valuation of a financial instrument. ... It would be inappropriate not to recognise a financial liability on the grounds that reliable measurement is not possible. ... The point is that once a financial instrument contract exists it should be recognised. It is proposed that no exemption from recognition should be given on the grounds of measurability uncertainties. Such an exemption would appear to be unnecessary, and allowing it creates potential for abuse.[135]

The underlying notions of appropriateness were informed by resolving the problem of management discretion resulting from idiosyncratic notions of financial risk. Shifting recognition guidance from notions of risks and rewards to control was seen to limit the potential for abuse. However, it transferred the burden of professional judgement from recognition to the area of measurement. Reliance on contractual terms and control for recognition guidance suggested that the scope for judgmental discretion previously involved

[134] IASC (1997a), p. 63.
[135] IASC (1997a), pp. 58-59, footnote omitted.

in recognition was resolved. However, the scope for judgment did remain. It resurfaced in measurement guidance, as one expert involved in the regulatory debate came to point out:

> *The way I look at it is ... you have the same amount of stress as today but the stress is all in the valuation. I don't think it has changed. I think it has moved. From a standard setters point of view, they can say, 'Hey, the accounting is functioning, what's your problem?' - You just can't do the valuation.*[136]

Referencing fair value

The consideration of current market values or, more conceptually, 'opportunity costs' in accounting received support from an academic debate that emerged when economists started to have a more profound influence on finance theory (Markowitz 1959; Sharpe 1970). Since the 1970s, substantial changes had taken place in the conceptualization of financial markets and firms. These changes can be seen to have encouraged standard setters to consider more thoroughly the financial economists' way of conceptualizing the firm as a collection of future cash flows, for instance, in the fundamental financial instruments approach. This interest was reflected in the first collective effort of the G4 in drafting a special report on the role of future events for recognition and measurement (Johnson 1994). This report stated:

> Selected issues that the working group has identified as variants of the future events question are discussed in the following sections of the study. In some instances, the questions primarily involve *recognition*, and in other instances *measurement*.[137]

Some aspects of the way the consideration of future events came to haunt guidance about recognition have been discussed in the last two sections together with its specific resolution in the IASC project. On the specific aspect of measurement, the G4 paper came to conclude:

> ... the majority view of the working group is that future events that will affect the ultimate amount of an asset or liability and are probable to occur should be considered in the measurement in the current reporting period. However, it should also be noted that a significant minority of the working group would not consider the effects of those future events in the measurement of the asset or liability because those events have not occurred and should not affect the measurement until they occur.[138]

---

[136] Interview c, December 1998.
[137] Johnson (1994), p. 3, original emphasis.
[138] Johnson (1994), p. 15.

The IASC's Discussion Paper 1997 came to suggest separating the aspect of reliable measurement from recognition guidance. Abandoning reliance on idiosyncratic constructs of financial risk and rewards for recognition were seen to involve parallel shifts in measurement guidance after initial recognition. In the different project documents, benchmarks for measurement thus co-evolved with changes in recognition guidance. While recognition guidance came to de-emphasize assessment of financial risks, notions of value came to gain prominence that associated effects of future events with current contracts. In particular the notion of *fair value* was seen to enable a shift in measurement from reliance on past transactions to consideration of proxies for future events.

Historical cost accounting had conveniently relied on past transactions to establish book values. As discussed with respect to provisions, reflecting more 'current' values within accounting measurement was seen to remain a judgmental act involving discretionary accounting techniques such as: depreciation, provisions, and what was more generally called reserve accounting. Gradually, considering *market values* came to allow accounting to represent values of items like traded investments, not just in reference to past transactions but in reference to *potential* transactions. While reserve accounting was being restricted, reflecting opportunity value in reference to potential market transactions came to be selectively considered in rules concerning, for example, current asset valuation and fixed asset impairment. For example, downward valuation was mandated very early in U.S. guidance in the 1940s to reflect potential losses, indicated by market value being below carrying amount:

> In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value.[139]

For some time afterwards, it remained contested whether impaired items should also become subject to revaluation, as suggested by the dissenting view of one Committee member, who rather proposed a full mark to market approach. He was quoted as stating that marketable

[139] ARB No. 43, chapter 3A, par. 9.

securities appeared to be close to cash and ...

> ... the market value is the most significant figure in connection with marketable securities held as temporary investments of cash, and would prefer to show such securities in the accounts at their market value, whether greater or less than cost. He would accept as an alternative the use of cost in the accounts with market value shown parenthetically in the balance sheet.[140]

The disagreement among the Committee members on loss recovery reflected the then prevailing inconsistent practice. For some decades, accounting guidance in the U.S. and elsewhere remained conspicuously unclear as to the point of value recovery. Only in 1975 did SFAS 12 require revaluation of marketable securities to historical cost after recovery of their market value. Corresponding gains and losses had to be included in net income of the period in which they occurred. Nevertheless, revaluation of marketable securities remained capped by cost. Exempted from the cost cap were those securities that were held by specialized entities such as investment companies, brokers and dealers in securities, as well as insurance companies. These instruments were to be accounted for on a mark to market basis, whereby the 'amount by which aggregate cost of the portfolio exceed[ed] market value [had to] be accounted for as the valuation allowance.'[141] At the same time, financial institutions came to manage their banking book differently from their market portfolio, which was marked-to-market on a regular basis for internal management. Increasingly, marketable securities came to be reported mark-to-market in external reporting as well (Macve and Jackson 1991).

In the course of the FASB's and the IASC's financial instruments projects accounting representation came to rely on a notion of value that went further beyond this early notion of market value. Market value was to represent the opportunity value in reference to a potentially available market transaction. While it allowed considering financial risk in selective reference to a current external benchmark, market value did not lend itself to a more general association of contingent future events with current contracts when appropriate potential market transactions were non-existent. Rather, venturing beyond market value

[140] Mr. Mason as cited in ARB 43, chapter 3A, par. 9.
[141] SFAS 12, par. 8. Firms following specialized accounting practices had to adopt market value accounting, if these practices permitted them to do so.

involved shifting the notion of what was to be called *fair value*.

Shifting the notion of fair value

The notion of fair value became part of the FASB's formal accounting guidance in its project on leasing. As U.S. GAAP embraced fair value measurement rather late and only after considerable debate, it is interesting to look at how the notion emerged in this jurisdiction before discussing its significance in the IASC project. SFAS 13 'Accounting for Leases', which was issued in November 1976 in response to the 'first off-balance sheet crisis', came to refer to fair value. Like the corresponding guidance in other jurisdictions, for instance, the U.K., SFAS 13 became seen as an attempt to implement a 'substance over form' principle. In SFAS 13, fair value became a benchmark for 'substance' in classifying leases into operating and finance leases. For example, the guidance required that if the present value of lease payments were similar to the fair value of a leased property the lease should be classified as a finance lease on part of the lessor. It defined fair value as the 'price for which the property could be sold in an arm's-length transaction between unrelated parties'.[142]

This already implied a notion of fair value that was broader than the notion of market value. The definition did not require that a potential market opportunity actually *existed*. It rather referred to an ideal-type exchange situation between willing and unrelated parties. However, restricting the use of fair values to cases were it could be 'objectively determined',[143] SFAS 13 envisioned values established by quotes from market makers or expert valuations. As suggested by subsequent uses of fair value, there was a demand for an *empirical* referent. However, a legitimate expert could credibly mediate the empirical referent. Thus, the ambiguity of 'how' to reference the ideal-type exchange was being resolved in terms of 'who' was eligible to construct the fair value (Power 1992).

The notion of fair value referred to in SFAS 67 'Accounting for Costs and Initial Rental Operations of Real Estate Projects', which was issued in October 1982, came to be close to

[142] SFAS 13, par. 5.
[143] Refer to SFAS 13, par. 28.

the notion of fair value underlying the standard on leasing. SFAS 67 was primarily seen as an appropriate extraction of existing specialized principles and practices. It appealed to fair value as a benchmark for classifying rather than for measuring items. In SFAS 67, relative fair value before construction was to serve as a key to allocate capitalized construction costs to parts of a parceled property. The definition of fair value was as follows:

> The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (i.e., selling price), that is, other than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors.[144]

While this definition was close to the one applied in SFAS 13, it specified in more detail the elements that needed to be considered in establishing fair value: physical characteristics, use, and specific conditions of the property. Although SFAS 67 referred to the abstract notion of 'willing buyer' and 'willing seller', it was to be closer to a going concern value rather than the value in an immediate forced or liquidation sale. The reference to fair value in this standard thus can be seen as aiming to maintain a balance between prescriptive detail and scope for professional judgement. However as a result of this balance, it still seemed to matter *who* did the valuation with what professional qualification (Power 1992).

Five years later, in December 1987, FASB issued SFAS 87 'Employers' Accounting for Pensions'. This standard came to establish more firmly fair value considerations for assets, not only to guide classification but also to guide accounting measurement. At the same time, it more firmly established reliance on professional judgement about associating future events with current contracts. The statement required recognition of a liability once the accumulated obligation under a defined benefit pension plan exceeded the 'fair value' of the assets provided for the plan. In the case of SFAS 87, the concept of fair value was defined as follows:

> The amount that a pension plan could reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a

[144] SFAS 67, par. 28.

forced or liquidation sale.[145]

In its basis for conclusions for SFAS 87, the FASB pointed out that it had favored fair value to actuarial value. Actuarial value was seen to be 'based on long-range projection of market values intended to eliminate short-term market fluctuations' and thus considered to be 'less relevant and more difficult to understand than fair value'.[146] In appealing to financial economics based theories of valuation, fair value was seen to provide the ideal of a more relevant measure that was not to be affected by discretionary estimates of management nor by the smoothing valuation methods of actuaries.

Idealizing the market

As these cases illustrate, the prevalent notion of fair value in the late 1980s, at the time when the financial instruments projects were taken up in the U.S. and internationally by the IASC, was thus rather ambiguous. On the one hand, fair value was characterized as a value that was to be established in reference to a *potential* market transaction and was thus seen as conceptually close to the notion of market value. On the other hand, as discussed above, fair value was often to be approximated by *expert valuation* by accountants or other experts, in particular if no references to straightforward market transactions could be made. In both cases, it was seen to be objective and representative of an unbiased transaction between willing buyers and sellers. It was this rather ambiguous (representative of the market but established by experts) notion of fair value that was coming to be adopted and gradually adapted in the financial instruments projects of the FASB and the IASC.

In the late 1980s, unlike the IASC's emerging guidance, the FASB project on financial instruments first embarked on market value rather than fair value. The regulatory debate leading to the subsequent adoption of fair value measurement reveals the notions of appropriateness that came to support the change from market value to fair value. The debate occurred in the context of what came to be SFAS 107 'Disclosures about Fair Value of Financial Instruments', eventually issued in December 1991. SFAS 107 was an extension

[145] SFAS 87, par. 264.
[146] SFAS 87, par. 119. Refer to Macve and Wild (1999) for a discussion of actuarial approaches of valuation in contrast to fair valuation.

and partial revision of the first financial instruments disclosure standard SFAS 105 'Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk', issued in March 1990. However, the 1990 Exposure Draft for what became SFAS 107 initially set out to address 'Disclosure about *Market Value* of Financial Instruments'[147] rather than disclosure about *fair value*. The exposure draft defined market value as follows:

> For purposes of this Statement, the market value of a financial instrument is the product of the number of trading units of the instrument times its market price - the amount at which a single trading unit could be exchanged in a current transaction between a willing buyer and a willing seller, other than in a forced liquidation sale.[148]

The 1990 Exposure Draft to SFAS 107 contained a comprehensive list of previous authoritative U.S. literature requiring the use of market value. Nevertheless, the proposed notion of market value seemed to be close to the FASB's previous definition of fair value. As in the case of fair value proxies, the proposed disclosure guidance about market values of all financial instruments, whether recognized or not, suggested referring to proxies for market value in case markets were illiquid. The FASB suggested considering 'practicability' or using proxies in cases where market value could not be established.

The comment deadline to the 1990 Exposure Draft was April 1991. After receiving more than 200 comment letters and holding a public hearing, demands increased to change reference in the title of the proposed standard from market value to fair value. By this time, the notion of fair value had become firmly established in the IASC's Exposure Draft E40, which contained similar disclosure requirements as the proposed U.S. guidance. It turned out that many FASB commentators considered fair value to be the more appropriate term for what was at stake, in particular as an alternative to market value in the emerging recognition and measurement guidance:

> The staff noted that the definition of a financial instrument and the definition of and the use of the term market value needs to be addressed. Mr. Beresford stated that in discussing the appropriateness of the definition of a financial instrument, the question of whether it should be consistent with the Discussion Memorandum on recognition

[147] Proposed title for what became SFAS 107, emphasis added.
[148] FASB (1990a), par. 5.

and measurement of financial instruments should also be considered.[149]

Although the FASB was discussing the notion of fair value in the context of a disclosure standard, the paradigmatic significance of the proposed notion of fair value for recognition and measurement permeated the debate. The staff of the FASB soon came to favor a switch to the term fair value. However, two Board members, Mr. Leisenring and Mr. Brown, disagreed with this proposed substitution of market value by fair value:

> Mr. Leisenring disagreed with the term *fair value*, stating that the Board's objective is market value, and therefore that term should be used. He suggested the term *estimated market value*, stating it would alleviate the concerns of constituents who felt market value implied a precision that was not necessarily present for instruments that are not traded.[150]

A report by the U.S. Department of the Treasury, issued in February 1991 and referred to in the FASB debate, had discussed the possible advantages of market value accounting from the perspective of a supervisory agency. The report synthesized the prevailing view on the issue of market value accounting and touched on whether proxy measures for market values would be appropriate. In this respect, it made reference of the notion of *fair market value*:

> ... to the extent that they utilize private information, fair market valuations based on discounted cash flow methods are not subject to the criticism that they fail to account for going concern values. Users may incorporate any private information they possess in estimating expected net cash flows from an asset, or in determining appropriate discount factors.[151]

In considering such private information, fair market value implied a much broader measurement concept than market value. It particularly allowed for expert evaluation of the future events that were seen to impact on expected cash flows. The report further argued to consider the going concern firm rather than liquidation values to approximate market values. This was seen to discharge some the criticism of market value accounting, namely that the liquidation values would be irrelevant for continuing businesses. The report further came to embrace consideration of specific assumptions about the reporting entities and management intent with respect to the question whether a trading unit concept should be used. The

[149] Minutes of the FASB's 20 June 1991 Board meeting.
[150] Minutes of the FASB's 8 August 1991 Board meeting, original emphasis.
[151] US-Treasury (1991), p. XI-12.

trading unit concept was seen to allow abstracting from the size of the portfolio of financial instrument to be valued by disregarding whether or not an investment was held for strategic purposes:

> Mr. Beresford expressed concern about the trading unit concept for a large equity interest in another company if the holder was able to determine a reliable estimate of the value of that investment. He felt that an estimate of value may be more relevant in certain cases than a value based on the market value per share and the number of trading units; ...[152]

Despite these concerns by the Chairman of FASB, in the published version of SFAS 107, the trading unit concept was retained, however, only for items that had a quoted market price. In allowing consideration of the specific values that certain instruments were seen to have in the specific context of an entity, the notion of fair value was considered more appropriate than the market value. In appealing to the ideal of a market transaction rather than an empirical transaction, fair value came to be seen as a more appropriate concept for measuring all financial instruments, whether they had a current market value or not. Subsequent to SFAS 107, the notion of fair value became firmly established in U.S. GAAP:

> For purposes of this Statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.[153]

Reflecting the initial disagreement at the Board level about the notion of fair value, the FASB claimed in the background information to SFAS 107 that the 1990 Exposure Draft and the final standard had intended to address the same concept. Both terms, market value and fair value, were argued to transcend the limits of empirical referents:

> The term *market value*, as defined in paragraph 5 of the 1990 Exposure Draft, is applicable whether the market for an item is active or inactive, primary or secondary. The Board decided, however, to use the term *fair value* in this Statement to avoid further confusion and also to be consistent with the terminology used in similar disclosure proposals made recently by other national and international standard-setting organizations [E40 of the IASC]. The concept of fair value is the same as that

[152] Minutes of the FASB's 8 August 1991 Board meeting, original emphasis.
[153] SFAS 107, par. 5.

of market value in the 1990 Exposure Draft ...[154]

Despite this declared equivalence, market value subsequently became a subcategory of fair value. In embracing the notion of fair value, the U.S. standard setter took the crucial step from requiring an *empirical* referent for measuring financial instruments to allowing a potentially *constructed* referent. Fair value encompassed the notion of market value, but appealed to an ideal market transaction and thus did not require a straightforward empirical approximation. Rather, the notion of fair value became associated with ideas about how markets were seen to work. It relied on a financial economics model about the way the market was establishing expectations about prices:

> Fair values of financial instruments depict the market's assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur.[155]

According to this model, investors were seen to base their expectations on present value calculations. Providing investors with fair value information that was based on the same principles was seen to allow confirming or even influencing those expectations. However, claiming to faithfully represent the market's assessment required an appropriate endowment with professional expertise. To support this claim, the standard SFAS 107 provided eight paragraphs of guidance on how to estimate fair value, in case a quoted market price would not be available. This guidance became further extended in subsequent standards like SFAS 115 'Accounting for Certain Investments in Debt and Equity Securities', issued in May 1993. Furthermore, a new concept statement (FASB 2000b) was published in February 2000, after an exposure draft had been published in June 1997 (FASB 1997b).[156] It was seen to empower accountants' judgements towards revealing fair value, while distinguishing it from what was considered the arbitrariness of management's beliefs about the future:

> While the expectations of an entity's management are often useful and informative,

[154] SFAS 107, par. 37, original emphasis.
[155] SFAS 107, par. 40.
[156] The Concept Statement No. 7 (FASB 2000b) sought to establish more general principles for using cash flow information and present value techniques in accounting measurement. It stated that the 'only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value' (par. 25).

> the marketplace is the final arbiter of asset and liability values. Present value measurements with an objective of fair value are, within the limits of estimation, independent of the entity performing the measurement. As a result, fair value provides a neutral basis for comparing one entity with another. ... fair value provides the most complete and representationally faithful measurement of the economic characteristics of an asset or a liability.[157]

This idealized notion of fair value came to map with the logic of appropriateness that had come to structure the regulatory debate. It found support from demands for limiting management discretion, it appealed to objectivity and it firmly confirmed a role for professional accountants. Fair value was seen to resolve the intricate measurement issues that resulted from the shifts in recognition guidance, which had abandoned consideration of reliable measurability. It appealed to values that were construed as if risk could be objectively considered, as if accounting could rely on faithful associations between future events and current contracts. Eventually, it allowed strengthening the credibility of accountants as if their professional expertise could establish neutral proxies for ideal market transactions.

Justifying the regulatory ideal

Meanwhile, in contrast to the FASB project, the IASC had embraced the notion of fair value right from the start of its financial instruments project. The IASC had come to refer to the notion of fair value as a proxy for the essence of market value in IAS 16 'Accounting for Property, Plant and Equipment', issued in 1982, where it had been defined closely to the definition then in use by the FASB. It appealed to the archetypical market exchange situation:

> Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.[158]

As we discussed for the FASB's early use of the term, fair value first became referred to as a benchmark for classifying items. In IAS 17 'Accounting for Leases', issued in 1982, fair value likewise served as part of a benchmark to distinguish between finance and operating

[157] FASB (2000b), par. 36.
[158] IAS 16 (1982), par. 7, original emphasis. IAS 16 was revised in 1993 to label this as the fair value measurement alternative.

leases.[159] Nevertheless, fair value in IAS GAAP also became a referent for measurement rather than for classification alone, and was closer in this respect to the U.K. guidance.[160] In IAS 16, fair value served as the basis for measurement on initial recognition, in the case that no monetary consideration was exchanged. Fair value was thus used as a proxy for market value as if a monetary consideration had been exchanged. It was argued that instead of exchanging non-monetary considerations, trading partners could have sold the non-monetary assets. Fair value was seen to approximate these potential market opportunities.[161]

In the context of establishing the cost of acquisition, IAS 22 'Accounting for Business Combinations', issued in 1983, considered ascertaining the fair value of assets either with reference to market values *or* other proxies. For assets without a liquid market, fair value was to be estimated by a 'variety of techniques':

> A variety of techniques is applied in arriving at fair value. ... When the market is unreliable or no quotation exists, the fair value of the securities is estimated by reference to their proportional interest in the fair value of the buyer's business or by reference to the fair value of the business acquired, whichever is the more clearly evident.[162]

The standard pointed to market value as a reliable indicator of fair value if an actual market existed. However, the standard did not elaborate further on techniques to estimate the amount at which an asset could be exchanged in the *ideal* market if no empirical referent existed. Fair valuing was not even considered problematic, suggesting that the professional expertise to construct fair values in these cases went unchallenged. Meanwhile, when IAS 25 'Accounting for Investments' was issued, in October 1985, the notion of fair value was broadened. It came to refer to an empirical market value of investment properties or to any appropriate 'other means' of establishing fair value:

> For some investments, an active market exists from which a market value can be

[159] It is interesting to note that IAS 17 was the IASC's first joint project with a national standard-setter. It was developed by a Steering Committee that was chaired by Paul Rutteman, who also chaired the corresponding U.K. project (Cairns 1999:635).
[160] For example, the U.K. exposure draft ED 30 'Accounting for Goodwill', published in October 1982, required assessment of the *fair value* of the separable net assets acquired in determining the amount to be attributed to purchased goodwill.
[161] Apart from IAS 16 and IAS 17, see also the early IAS 18, 20 and 22.
[162] IAS 22 (1983), par. 16. IAS 22 was revised in 1993.

established. For such investments, market value is an indicator of fair value. For other investments, an active market does not exist and other means are used to determine fair value.[163]

IAS 25 allowed to account for investment properties classified as long-term investments to be carried at fair value with cumulative gains reported in equity and cumulative losses reported in income. The guidance in IAS 25 left open whether 'other means' to establish fair value needed to involve an empirical referent or a non-accounting expert valuation. In principle, it seemed to suggest that sophisticated and abstract modeling techniques would be accepted to approximate fair value, like, for example, discounted cash flow or other estimation techniques. While the definition itself did not change much compared to previous guidance, the selective reference to fair value for measurement on initial recognition was broadened in the course of the financial instruments project.

By the time IAS 32 'Financial Instruments: Disclosure and Presentation' was approved, in March 1995, fair value had more explicitly taken on the broader meaning discussed with respect to SFAS 107.[164] In the context of IAS 32, which came to mandate fair value disclosures for all financial instruments, fair value represented more broadly the value a financial instrument was seen to have within the particular context of an enterprise. This could be either in reference to a market value or in reference to an established valuation technique, if a market value was not available or, because of lack of liquidity, not indicative of the fair value:

... estimation techniques may be used to determine fair value with sufficient reliability to satisfy the requirements of this Standard. Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. ...[165]

---

[163] IAS 25, par. 6.

[164] IAS 32 (1995), par. 5 states: "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (original emphasis). This was the same definition as the one used in IAS 16 for the fair value of assets. Paragraph 8 added a going concern presumption: "Underlying the definition of fair value is a presumption that an enterprise is a going concern without any intention or need to liquidate, curtail materially the scale of its operations or undertake a transaction on adverse terms." This had become part of the FASB definition of fair value before. Meanwhile, inclusion of transaction costs in the calculation of fair value was eliminated in the course of revising IAS 32 in 1998.

[165] IAS 32 (1995), par. 82.

An appendix to IAS 32 provided more detailed examples and application notes than any previous IASC standard appealing to fair value. The higher profile of fair value disclosures for financial instruments appeared to demand more institutional support. Thus, to disperse public doubt about the accounting claim for fair valuation, the guidance seemed to support closure on a social as well as technical level (Latour 1987; Power 1992). As the belief in the valuation came to hinge on the social credibility of the valuers and their techniques, it seemed important to expand the abstract knowledge base of the valuation techniques employed. On the technical level, the regulatory discourse seemed to rely on a virtuous circle presuming that once construed values would be mandated, appropriate valuation techniques would become more broadly accepted. The IASC referred to the FASB's guidance where appropriate techniques to determine fair value were expected to emerge with the requirement to provide them:

> The Board believes that the increased use of fair values in financial reporting ... will result in increased availability and reliability of fair value information.[166]

The expectation of increased availability and reliability of fair valuation techniques came to shift the notions of what accounting appropriately can and should represent. SFAS 115 mandated fair value measurement for trading portfolios and securities. The appropriately demanded application of fair value thus remained limited to a subset of instruments, which, according to management intent, were *not* going to be 'held to maturity'. Eventually, the FASB took a further step in the application of fair value with respect to recognition and measurement of derivatives and hedging instruments. This endeavor came to lead to SFAS 133 'Accounting for Derivative Instruments and Hedging Activities', issued in 1998, which relied on fair value measurement not yet for all financial instruments, but for *all derivatives*.[167]

In contrast to the FASB's 'piecemeal approach', the shifting notions of what accounting

[166] SFAS 115, par. 43 (background information and basis for conclusions).

[167] Meanwhile, SFAS 133 was not the final word on financial instruments by FASB. After facing considerable opposition in the course of finalizing the standard, it seemed to be even more difficult to implement it (FASB 2000a). Nevertheless, the FASB remained involved in the comprehensive project on financial instruments, which was undertaken by the JWG under the umbrella of the IASC.

appropriately can and should represent found an even stronger expression in the IASC's Discussion Paper published in 1997. This paper undertook the attempt to develop a coherent measurement basis for *all* financial instruments, whether derivatives or not. It mandated the same measurement principles for all instruments independent of management intent. It embraced fair value in its broadest sense, comprising both market value and professional valuation techniques. Interestingly, unlike most of the previous literature, the IASC Discussion Paper came to embark on a more explicit theoretical argument for the use of fair value.[168] After analyzing the existing accounting guidance on measurement after initial recognition, the authors, a Steering Committee chaired by Alex Milburn, came to conclude:

> The conceptual and practical merit of measuring financial assets and financial liabilities at fair value is evident in the rapid growth of financial instruments and their use in managing financial risks, and in the ease with which financial assets and financial liability risk positions can be realised or transformed using derivatives in now well developed global markets. The fair value measurement concept is founded on sound economic theory that is widely recognised and accepted in financial markets.[169]

The paper argued that financial economic theory about pricing of securities might be extended beyond markets to proxy values that were established *as if* there was a market value. The tenet of financial economics was seen to be that in developed financial markets, the market value of a financial instrument will reflect all information that is known in the market place. That the market value, at any particular time, embodies the market's assessment of all economic events up to that time, was argued to be ...

> ... the essence of "efficient" capital markets theory ... accepted to be the way in which developed financial markets work. ... These capital market pricing concepts can be extended beyond market values for actively traded securities to the broader concept of "fair value" in respect of non-traded financial instruments. ... In other words, even if a financial instrument is not traded in an active market, its fair value can be expected to be determined by reference to competitive prices for the particular financial risks inherent in its contractual rights or obligations. ... This fair value concept may be expressed in terms that connect the accounting definition of "fair value" to accepted capital markets pricing concepts and practices as follows: The fair value of a financial instrument ... represents the present value of its expected future cash flows discounted at the current market rate of return for instruments of similar term and risk.[170]

---

[168] An exception is the ASB's Discussion Paper (ASB 1996), which will be discussed in more detail in chapter five.

[169] IASC (1997), p. 119.

[170] IASC (1997), pp. 84-85. Implied in this argument was the idea that to be fairly priced instruments

Fair value was seen to be the implicit model that participants in markets employed when valuing financial instruments and thus to represent the logic of market valuation and pricing of risk. As such it inspired the regulatory debate, serving as an ideal of desinterested objectivity to which accounting guidance was to aspire. While acknowledging that practice would always fall short of fulfilling this ideal, the promised replication of the valuation of markets seemed feasible if ever in the case of financial instruments. As an approximation of the *telos* of measurement in financial reporting, the notion of fair value gained a transcendental dimension providing meaning for accounting and direction for accounting regulation.

The idea of fair value, while fundamentally ambiguous and abstract, became an indispensable element in the network that supported notions of accounting's possibilities and thus came to structure the further accounting debate. By providing meaning to accounting, it came to shift notions of appropriateness. Emerging notions of appropriateness came to further strengthen the claim to fair value measurement. In the regulatory debate of the late 1990s, fair value came to serve as an ideal, which was never to be fully fulfilled. Aiming for it became seen as appropriate. It gave rise to further regulatory initiatives thus reinforcing the 'systemic' logic of accounting regulation.

The IASC Board never fully endorsed the Discussion Paper 1997.[171] Nevertheless, the notion of fair value as defined in the Discussion Paper 1997 came to be an important element in the accounting guidance proposed by the IASC as Exposure Draft E62, published in June 1998. However, this exposure draft, like the resulting standard IAS 39 'Financial Instruments: Recognition and Measurement', finally issued in March 1999, mitigated the requirement for fair valuation. The classification of financial instruments came to rely on intent and management's constructs of risks associated with future events. For example, it allowed instruments to be classified as 'held to maturity' and allowed historical cost

---

do not need to be traded as long as they can be replicated by traded instruments. A similar argument was used by Black and Scholes (1973) to price options and corporate liabilities.

[171] Starting with the Steering Committee that drafted the Discussion Paper 1997, it became possible for Steering Committees under the IASC jurisdiction to develop quite independent intellectual positions. The later Joint Working Group on Financial Instruments came to continue this tradition of independence.

measurement for some of these.[172] However, E62, like SFAS 115 and the Discussion Paper 1997, maintained the aspiration to provide more fair value. E62 went as far as to presume that it was unlikely that an entity purchased a 'financial instrument for which it does not expect to be able to obtain a reliable measure of fair value after acquisition'.[173] This suggested that it should be possible, in principle, to establish fair value thus resolving the intricate question of whether financial instruments were reliably measurable or not. In the standard that was subsequently adopted as IAS 39, this was expressed more cautiously as follows:

> There is a presumption that fair value can be reliably determined for most financial assets classified as available for sale or held for trading. ...[174]

This presumption hinted at what became seen as increasingly sophisticated markets for risks associated with financial contracts involving cash flows whose certainty was contingent on future events. Markets for major types of risk were assumed to either already exist, or to emerge in the not so distance future. Where they did not exist, increasingly sophisticated models were believed to allow pricing even of illiquid exposures. There was evidence of an increasing number of asset securitizations and increasingly sophisticated models for pricing different types of market risks as well as credit risk.

The late 1980s and 1990s saw the emergence of an intellectual agenda to move towards a 'full fair value model'. What was initially discussed as 'mark-to-market' model, further developed in the emerging guidance and the IASC's Discussion Paper 1997, came to be further pursued within the comprehensive financial instruments project under the JWG, which was set up in 1998. It also led to a new concept statement of the FASB in 2000. The challenge in this intellectual pursuit was to develop guidance as to associate accounting closer with the ideal of fair value. The notion of fair value was seen to offer new opportunities for regulation and to give new significance to accounting and to extend the professional realm of accounting by shifting the boundaries of what accounting can and

---

[172] Refer to appendix A4 for a more detailed discussion of the differences in measurement guidance between the Discussion Paper and IAS 39. The classification was an import from the U.S.
[173] E62, par. 66.
[174] IAS 39, par. 70.

should represent. More generally, the notion of fair value allowed accounting to reach out to represent financial risks.[175]

Resistance at the margins of accounting

Irrespective of the valuation intricacies involved in applying fair value measurement, accounting regulators became increasingly enthusiastic about this notion. However, as it shifted the boundaries of what accounting can and should represent, fair value measurement alienated many practitioners and preparers but most clearly the banking industry. As discussed in chapter three, the IASC's financial instruments project set out to make visible the risks inherent in *all* financial instruments. The emerging recognition and measurement guidance thus came to affect instruments that traditionally had been recognized and measured on the balance sheet under the historical cost model or not recognized at all. What had started as an attempt to recapture representation of off-balance sheet risks of banks, eventually came to trigger an accounting revolution to apply fair value measurement to all financial instruments. Initially, this was seen to gain support from the way many banks were internally (and increasingly externally) reporting their exposures to credit and market risks. In particular banks with substantial trading books were seen to expand the market risk approach in their accounting systems to items that were previously accounted for under the traditional accounting model (G-30 1993; FEI 1994; ACT 1995).

Thus, internal risk representation increasingly relied on estimating the fair value of the items and by analyzing the changes in their fair value, the 'value at risk', under different short-term scenarios, for instance changes in interest rates.[176] Risks involved in the trading and the banking books of banks became increasingly conceptualized under integrated approaches that applied the concept of value at risk (Beder 1997). Experts thus came to speak of the value-at-risk approach as an alternative to the conventional approach of asset-liability management. Eventually, by the mid-1990s, what had started in pure trading operations was seen to gain increased following throughout the financial industry. It fostered the image of

[175] The latest steps towards fair value accounting include IAS 40 and 41.
[176] Refer to chapter one, table 1.1, for an illustration of this approach.

an emerging reality were risks were made visible in a *single number*, the fair value. And this image of reality was increasingly shaping the notions of what accounting should represent:

> Whatever the difficulties, the aim of getting an integrated picture of a firm's exposure to market risks is worth a number of assumptions, some of which may be reasonable representations of reality. ... Looking at risks in this fashion may be misleading. This is the direction of the industry and its accounting regulators however and it will be up to financial analysts to adapt to the new environment. The volatility of earnings will not just appear out of the blue. The changes in accounting practices will ultimately show economic reality as it really is.[177]

As mentioned in chapter three, traditionally, banks had come to rely on reserve accounting to selectively represent those risks that they were willing to assume and manage in their banking book. The conventional approach of asset-liability management was based on the assumption that credit risk and interest rate risk could be managed separately. This clashed with the emerging notion of 'reality as it really is'.[178] Lobbying against the fair value model increased with the progress of the project with the most visible lobbying and the fiercest resistance coming from banks. The life insurance industry initially became exempt from the emerging guidance on fair value measurements of financial instruments as it was seen to work with actuaries and accounting guidance specific to their industry (Horton and Macve 1995; Macve and Wild 1999). Bankers, however, were required to adopt fair valuing of all their financial instruments, although they saw themselves involved in the business of risk assessment and management:

> *Banks are in the position of assuming risk that thus put them in a different position. They are also regulated and that should not be lost sight of. They have very high reporting requirements and intrusion into their management under the regulation - quite rightly, because they are public interest companies. ... They have separate schedules in the Companies Act to reflect the fact that they have a very specific accounting directive they report under that puts in place distinct requirements.*[179]

Arguments by bankers in the U.S. and Europe against the proposed fair value proposals relied on pointing to the specificity of the traditional banking business and the particular

---

[177] J.P. Morgan/ Reuters (1996), p. 24.

[178] See, for example, Arthur Levitt, Chairman of the Securities and Exchange Commission (SEC), in hearings of the U.S. Senate's Banking subcommittee on securities in October 1997, who argued that FASB's proposal would not create volatility, but that existing volatility was not reflected in financial statements (Davis 1998:31). Refer also to the discussion in the next chapter.

[179] Interview M, August 1998.

way in which risks in the banking book were managed. The proposed abandonment of hedge accounting for macro hedges and hedges of future transactions was feared to result in income volatility and was seen to create an impression as if banks had been exposed to increased financial risks. Introducing fair value measurement for all financial instruments was seen to subject financial institutions to systemic risks. In the debate leading to SFAS 133 it was argued that the proposed hedge accounting,[180] which was also adopted by the IASC in IAS 39, a simple interest rate swap to convert floating-rate debt to fixed rate would expose the entity to volatility in comprehensive income and net worth. This would be the case, although the economic effect of the swap would be to fix future cash flows that otherwise would be variable.[181] Fair value measurement was seen to force banks to change their asset portfolios towards shorter maturity investments - with perceived economic consequences:

> *Someone whimsically told me that he thought SFAS 133 would survive until one of the American houses failed as a result of the accounting. And then they would realize that prudence actually has a very important role... But prudence has a very important role when you are dealing with institutions that take public money, which is what we are. Go back a century of banking history, bank failures have been because of imprudent behavior along with accounting which has not been very conservative.*[182]

In 1997 the financial instruments debate was seen to shift into high political gear (Davis 1998). U.S. Senator Lauch Faircloth, a member of the financial institutions subcommittee of the Senate Banking Committee, introduced a bill aiming to exempt some U.S. banks from FASB's proposed accounting standard for derivatives and hedging that partly relied on fair values. Alan Greenspan, Chairman of the Federal Reserve Board, the banking supervisor, warned FASB not to adopt a fair value model too fast. Echoing the criticism of banks, he rather suggested to maintain the historical cost financial statement framework and to improve disclosures to reflect risk exposures and the underlying economics of transactions:

> ... provided such disclosures are initially limited to larger market participants and are coupled with enhanced accounting guidance on the estimation of fair values. This alternative approach seeks to avoid the problems associated with piecemeal

[180] Which was close to mark-to-market hedge accounting discussed in chapter one, tables 1.4 and 1.5.
[181] Roger Trupin, Comptroller of Citicorp, in hearings of the U.S. Senate's Banking subcommittee on securities in October 1997. See also the example in chapter one.
[182] Interview U, October 1998.

approaches to fair value accounting, as proposed by the FASB, and with a rapid movement to fair value accounting, which has been proposed by the International Accounting Standards Committee (IASC).[183]

However, while accounting regulation of financial instruments aimed at appropriately representing reality as it became visible under fair value measurement, standard setters were underestimating the constructive power of accounting. Traditional accounting had created a visibility of financial risk, which in turn had shaped notions of appropriateness and perceptions about the relevance of the representations. To the degree that traditional accounting had shaped notions about what risks were considered as real, genuine concerns about the construction of risk representations seemed to float beneath the fierce political meddling. These concerns about the constructed visibility of risks under the fair value approach surfaced in comments on particular features of the proposed guidance. In traditional financial reporting, banks had been able to separate different types of risk by provisions, like credit risk, and by hedging other market exposures such as interest rate risk. Reporting these risks as part of either equity or income, as suggested by the fair value alternative, was seen as meaningless.[184] It was seen to clash with the purpose of financial intermediation, as bankers perceived it:

> *Banks fundamentally - the commercial banks not the investment banks - are there to affect maturity transformation. You know we take short-term deposits ... and we extend the life of those deposits and we then lend long term. We lend long term to people for residential mortgage; we lend long term to major companies to provide financing for their business.*[185]

The fair value system did not seem to allow for an appropriate portrayal of the banking business and those financial risks that were seen to relate to maturity transformation. If assets and liabilities had to be regarded independently of each other at their fair value, the association between assets and liabilities in the context of the firm that managed maturity transformation became disregarded. While banking representatives came to agree that the

---

[183] Letter Alan Greenspan, Chairman of Board of Governors of the Federal Reserve System, to Edmund Jenkins, Chairman of FASB, 31 July 1997.

[184] As discussed in appendix A4, even the IASC Discussion Paper 1997 allowed reporting fair value changes in either income or equity. This will be discussed in more detail in chapter five with respect to the ASB proposal to report certain fair value changes in neither income nor equity.

[185] Interview U, October 1998.

risks entailed in financial instruments were often not properly reflected by their balance sheet values, they hardly considered a fully-fledged fair value model to be superior in representing financial risks:

> *You're not showing anything to do with volatility, which is effectively, what you are trying to get at. You are trying to get to the volatility level. You're not. All you're doing is showing something at a point in time. And, yes, you will have another point in time in a year and you can look at what has moved in between, but it's got to be debatable. I think, I mean, we have always taken the view that if what you want to show is risk, you have to be looking at disclosures. Balance sheet values can't capture risk. They can capture the effects of risk at a point in time, but they can't capture risk.*[186]

Fair value represented a value at the balance sheet date. As a reference to the ideal market transaction, this value was to include the fair assessment of the contingency of future events; it was thus seen to reflect financial risks. At the same time, the single number of fair value was seen to be in sharp contrast to the construction of financial risks in specific provisions, for example for credit risk, to which firms and particularly banks had become accustomed. Accounting for credit risk in the fair value model depended instead on impounding the price of risk in the fair value calculation. Even in cases were no liquid markets for credit risk existed, it was argued that credit risk needed to be included in the risk-adjusted discount rate or included in the risk-adjusted estimation of future cash flows (FASB 2000a). However, as banks argued, the assessment of credit risk in a private portfolio of loans was an enormously judgmental act. The biggest source of banks' losses was seen to relate to misjudging their credit risk. Establishing acceptable levels of risk was seen to be at the core of the banking activity and to emerge under consideration of multiple factors that needed to be balanced:

> *And, you know, it's this fine balance between, you know, pricing the level of risk you're willing to assume, pricing in light of the relationship that you've got, pricing in relation to the income that you gain from a particular customer grouping. And it is information about credit quality, credit risk, credit loss, and provisioning and spreads and margins, and whatever, that is particularly relevant to the banking book.*[187]

The single dimension of fair value as a comprehensive measure of financial risk was seen as unrepresentative of the fine balance of multiple factors involved in considering and

[186] Interview S, August 1998.
[187] Interview M, August 1998.

constructing financial risks. Without any apparent benefit for the management and representation of banks, it was not seen to conform to the way, banks were looking at their activities themselves, it was feared that fair values would present inherently profitable banking books as risky. To the degree that banks were involved in maturity transformation, fair valuing their assets and liabilities would appear as risky:

> Under a fair value accounting regime, the possibility exists that these deposits would be valued, using present value techniques, at either face value (for call deposits) or close to face value (for short-term deposits). However, longer term assets funded by such liabilities would be measured at lower values, thus creating operating losses. It is important to ensure that an accounting practice is not introduced which may show accounting losses occurring from activities which are in themselves inherently profitable.[188]

This, however, was the usual case for deposit-taking institutions, which financed long-term loans by short-term deposits and borrowings. Commercial banks borrowed short, lent long and earned a margin in the process. This was done in the expectation - based on experience - that a certain percentage of call or short-term liabilities were relatively inelastic to changes in interest rates and could be maintained at predictable levels. Although behavioral assumptions to model the effect of interest rate changes in deposits involved crude estimates, consistent fair valuing of core deposits would have resulted in realizing immediate profits when deposits were taken on.

> *Yeah, I mean one of our members, and he isn't alone, but he puts it very starkly. He says, 'if I'm a bank and I take deposits from the public and I pay very low levels of interest on those. So actually as soon as I take a deposit I make a profit.*[189]

Meanwhile, although banks argued that the behavior of depositors was predictably inelastic, standard setters were reluctant to allow banks to adjust the fair value of their core deposits, mainly because it was seen to involve private information. On the other hand, as most of the assumptions underlying the construction of fair values would have to remain oblique, it was not seen to support analysts in their assessment of bank performance either.

---

[188] Comment letter to IASC Exposure Draft 40 by National Australia Bank, 1 June 1992. Because of their different duration, long-term assets and short-term liabilities would have different sensitivities to changes in interest rates.
[189] Interview S, August 1998.

> Even after the issuance of SFAS No. 107, "Disclosure About Fair Value of Financial Instruments", financial analysts in the U.S. have repeatedly commented that they do not believe that disclosure of fair values will have significant meaning ... at the end of the day, banks must be measured on the success or failure of their business strategy, that is, how well the bank employed its credit insights gained through the credit risk management process to acquire a diversified portfolio. Clearly the success or failure for commercial banking activities should not be evaluated on the basis of a price that indicates value in the context of immediate delivery ...[190]

Banks insisted that net interest income based on historical cost accounting after provisions for credit risk would provide a more meaningful performance measure. They therefore suggested to distinguish financial instruments held in the banking book from other financial instruments based on the way the banking book was internally managed. Thus, the external accounting would remain consistent with the way commercial banks traditionally were seeing and managing their enterprise. It would be meaningful, as it was focusing on net interest income and net interest margin.

> *If you take a loan book, any loan book - it doesn't really matter which - but if you take a traditional loan book, you know the business is done for to earn a margin essentially. And that margin is earned over a period of time, you start fair valuing, you're all over the place - assuming you can fair value - but you're all over the place. It doesn't ... I think the argument there goes that that doesn't reflect the reason why the business was done, the way the business is managed, the effort that goes into running the business over a period of time. You know. Matching concepts go out the window.*[191]

While fair value came to represent a regulatory ideal that shaped the notion of what accounting can and should represent, it challenged the way banks were seeing their business. The ideal possibilities of accounting became associated with practices of advanced risk management techniques developed by banks, with asset securitization and financial engineering. However, banks considered the basis on which these techniques relied as specific and as requiring banking expertise. After all, financial risk management was seen to be at the core of the banking business. The justification for having commercial banking

---

[190] Comment letter to IASC Exposure Draft 40 by Chemical Banking Corporation, 15 June 1992. In this respect, banks received some support from studies undertaken by the Jenkins Committee of the AICPA. A series of focus group meetings undertaken by the Committee had not delivered substantial support for fair values in financial statements. However, the interpretation of the focus group transcripts has been ambiguous. They were also referred to by proponents as delivering *support* for fair values (FASB 1998a)

[191] Interview S, August 1998.

relied on *the difficulty* to establish fair value. The *imperfection* of financial market transactions, not their ideal, justified the existence of banks. Banking expertise was deemed important for doing over the counter transactions and intermediation in markets not conforming to the ideal that accounting regulation aspired to. The fair value model relied on the regulatory presumption that markets or appropriate accounting techniques for fair values of most financial instruments would evolve over time. However, as bankers noted:

> *You barely need a sophisticated understanding of the market to recognize that, you know, the market price, and the circumstances of the market price vary considerably, depending on the volume and the depth of the market. And I still do not believe that in this country [U.K.] we are at a stage where this massive block of assets ... that they are saying for one reason or another you can put a value on. Because, you know, small amounts are traded. Or small elements have their risk traded or modeled. And I certainly have been in a meeting with one regulatory group, when they said, oh, but look at credit derivatives. Wow, great, the credit derivatives amount to ... even if they are running into sort of several hundred million or billion dollars. One, that is still a miniscule part of the market. And two, an awful lot of that growth has been in very niche markets and doesn't apply to the areas where we have a concern.*[192]

To banking representatives, the conceptual simplification of 'arm's length transaction among knowledgeable and willing partners' for many illiquid instruments appeared to be fundamentally flawed, despite the fact that banks themselves were securitizing parts of the their long-term assets. However, securitization was seen to involve specific and costly banking expertise; transaction partners were not 'knowledgeable' enough to transact without an intermediary. On the other hand, bankers accepted that even illiquid financial assets were increasingly being securitized and formerly illiquid assets were becoming commodities.

> *If you argue only on the reliability issues, you've lost the argument. Because the IASC will say OK, we accept that. We will write a standard that says anything reliable you put on a fair value basis, if it's not reliable you don't. And in five years time maybe markets will have changed and there will be huge pressure to move to that basis.*[193]

Meanwhile, in an ideal world where financial markets allow reliable measurement of all financial instruments no need for financial intermediaries would exist. As long as banks were still actively involved in commercial transactions, the fair value measurement was seen to be inappropriate for representing the balanced layers of risks banks were seen to manage.

---

[192] Interview M, August 1998.
[193] Interview U, October 1998.

With respect to their banking book, they fundamentally did not believe that the single number could ever be meaningful:

> *You can't measure it with any degree of certainty, and we certainly would be fundamentally opposed to having those numbers reflected in our accounts. Because we don't think that the management of the banks ... it just doesn't use fair values. And ... we are managed on the basis of holding these assets and liabilities for the long term and not to trade them.*[194]

Furthermore, fair valuation was seen to force banks to abandon their traditional management of market risks and hedging strategies that locked in interest margins. In a fair value model, value changes of instruments that had previously locked in differentials in interest rates by fixing them would off-set any hedging gains or losses from fixing the rates. Neither did banks share the notions of appropriateness that there was any benefit in reflecting fair value changes resulting from interest rate changes, as all that mattered was the original loan amount, rather than the transient fair value. Banks considered themselves hedged from interest rate risks, if they lent fixed rate out of a pool of fixed rate money.

> *OK what is the purpose in marking those things to market, because they would all come back to 100 ... at the end. And in the meantime, if one of them does go up to 120 or down to 80, I've got a matching liability that does the exact opposite so the net effect is nil. And that's how I run the bank. And, you know, what's the purpose in having both swinging up and down in a way that cancels out?*[195]

On the other hand, banks increasingly accepted that disclosure of fair values and maturity profiles was something they had to accommodate. While banks rejected the recognition and measurement guidance proposed under the fair value model for reasons of risk representation, they were seen to support improved disclosure guidance.

> *So transparency is good, that's a starting point. And in discussions with the [U.K.] Accounting Standards Board, we kept coming back. ... And I think there is a sentence in their discussion paper ... that pretty much says the reason why we want information on fair value is because it tells us about risk. Now actually we think if what they want is information about risk, why don't they develop other risk disclosures?*[196]

---

[194] Interview U, October 1998.
[195] Interview O, August 1998. See also the discussion in the next chapter.
[196] Interview M, August 1998.

Meanwhile, despite agreement about the usefulness of disclosures in general, considerable doubts about the types of disclosures that analysts were requiring remained. These doubts and the limits of what banks were willing to disclose left disagreement even on disclosures. After all, risk management was part of their core business and banks did not want to be forced to reveal too much of the views they were taking.

Much of the regulatory debate on fair value measurement was couched in terms of adverse economic consequences. However, as we came to argue in this section, the debate crystallized very different conceptualizations about the role of accounting, in particular with respect to representing financial risks. While the notion of fair value was providing a regulatory ideal to which regulators came to aspire, it was seen to be in fundamental contrast to the way banks had been conceptualizing their commercial banking activities. While fair value was promising accounting regulation to consider financial risks more broadly, it failed to be congruent with the way banks managed financial risks in their traditional banking book. The notion of fair value appealed to an ideal market transaction. However, financial intermediaries were seen to operate in financial markets that were not ideal in this sense. For regulators and banks, these points of difference informed different notions of appropriateness, with banks considering historical cost accounting to be more appropriate:

> *The basis on which we state our arguments takes us right back to the fundamental principles of why we have financial statements. And that is because people want to have a very clear understanding of the governance of the company and the financial state of the company. And although, you know, historical cost of a loan book minus provisions might not be very sophisticated, it does actually mean that year on year you have a very ... you have a pretty good picture of the cycle of how well that bank has been run. ... And you have a good basis on which to compare banks.*[197]

Discussion

One fundamental limitation of the accounting representation of financial risk was that it provided a measure at a point in time. Even a simple representation of risk, however, was seen to involve a second moment, a difference, for example, the difference between two values that might be attributed to a change of 'something' as the source of risk. Largely due

[197] Interview M, August 1998.

to this limitation of accounting proper to provide only point measures, regulatory attention came to focus on improving disclosures rather than accounting itself (SEC 1997). However, as discussed in this chapter, notions of risks and their representation also came to play a central role in debating guidance on recognition and measurement for financial instruments. The regulatory debate on recognizing and measuring financial instruments became highly immersed with different understandings of the way expected future financial outcomes were associated with past actions. Luhmann (1993) referred to these as different constructions of risk.

In traditional accounting, representations of financial risk were seen to rely on idiosyncratic assessments of future events and were largely left to management discretion. Much of the regulatory debate on financial instruments may be understood as an attempt to limit this discretion and establish a firmer basis for the consideration of future events in accounting. Management discretion in constructing financial risks became a regulatory issue whenever reserve accounting and provisioning were seen to be misleading. In particular, as recognition criteria came to rely on notions of 'risks and rewards', many of the off-balance sheet 'holes' in accounting in the 1980s came to be attributed to selective constructions of financial risk. Financial instruments projects emerged in the context of such longer lasting and still ongoing attempts to represent the contingent effects of future events in accounting.

Rather than considering accounting regulation as improving the representation of reality *per se* the regulatory debate was analyzed in terms of the shifting notions of appropriateness of what accounting can and should represent (Hopwood 1987; Hines 1988; Power 1996). These notions were seen to depend on the support they found in the supporting network of experts, ideas and organizations that came to structure the regulatory debate and was seen to grant meaning to accounting constructs. The analytical focus in this chapter has been on the appropriateness of constructs of financial risk, tracing the emergence of accounting concepts that became seen as less discretionary. Three important interrelated aspects characterized this emergent guidance for financial instruments. The first aspect was the *separation* of recognition guidance from measurement. The second aspect was the *limitation of discretion* in recognition and the third aspect was the increasing reliance on the notion of *fair value*. As

we discussed in the last section of this chapter, the notion of fair value as an accounting measure that reflected financial risks came to face considerable resistance. Banks claimed the task area of presenting and managing financial risks, which informed notions of appropriateness of accounting representations that were different to those of the standard setters.

Notions of appropriateness that attempted to strengthen associations between contingent future events and particular instruments came to immerse the international financial instruments projects. Off-balance sheet financing brought to the fore the ambiguity of recognition guidance that relied on inconsistent consideration of risks and rewards. Claims to representing all financial instruments, and the financial risks they entailed, involved strengthening the expert status of the accountant and the recognition and measurement guidance on which his status relied. In strengthening the claim to represent financial risks, accounting representations became more isomorphic with the way financial instruments were seen to be used in financial markets. This involved the separation of recognition and measurement criteria supported by the idea that, financial instruments could be measured otherwise they would not be taken on. To capture all financial instruments, recognition was to be triggered irrespective of the perceived measurability of the risks and rewards associated with the contract. Instruments needed to be recognized when a contract established a financial instrument. Focusing on the contractual terms and drawing on the notion of financial instruments thus strengthened the binary distinction between items on and items off the balance sheet. All contracts involving financial instruments had to be recognized, irrespective of the measurability of the risks and rewards associated with them.

The shift in recognition criteria, as it resulted in recognizing previous off-balance sheet items, required a complementary shift in measurement guidance. Before the financial instruments projects were taken on, measurement of items after initial recognition had selectively referred to empirical market transactions for indicating adverse expectations about the future. In the course of the project, fair value emerged as the conceptual measurement basis for financial instruments, supported by some of the experts. When the IASC's Steering Committee published its Discussion Paper 1997, the notion of fair value

came to involve reference to an ideal model of market pricing for which any empirical market value was just one possible approximation. This reference to the ideal-type transaction extended the scope for accounting representation. In embracing fair value measurement, the project that started off as a search for ways of representing off-balance sheet risks of banks was establishing claims concerning the representation of financial risks more broadly. While the debate black-boxed the truly intricate measurement issues, the projects came to rely on the presumption that, over time, measurement technologies would evolve to reliably fair value most if not all financial instruments.

As fair value seemed to be the implicit model employed by market participants, it came to serve as an ideal of objective measurement to which accounting valuation was to aim. Promising a replication of the valuation of financial instruments in ideal markets, the notion of fair value served as a regulatory ideal, providing meaning for accounting and a direction for accounting regulation. This regulatory ideal, while empirically ambiguous, came to shift the notions of appropriateness that structured the accounting debate. The representation of value and risk became meaningful in reference to the unbiased market transaction, the transcendental conjunction of demand and supply. Aiming for an ideal that was never to be fulfilled justified ongoing regulatory initiatives. Better accounting was to become better in terms of its closeness to the ideal of fair value. The notion of fair value thus offered a 'program' for the 'systemic' logic of accounting regulation, for justifying and reproducing itself.

The systemic logic of accounting regulation to represent financial risk as implied in the notion of fair value was at odds with bankers' understanding of financial risks and their representation in accounting. In particular banking representatives strongly rejected moving towards fair value measurement for their traditional banking book. Fair value was not seen to correspond with the risk management techniques adopted by commercial banks as part of asset-liability management. Rather than embarking on the logic dominating the regulatory discourse, bankers were seen to approach the valuation of financial instruments in financial markets with a commercial logic. Their existence was justified by the roles of commercial banks as intermediaries in markets that lacked transparency and as managers of risk in

maturity transformation. These roles suggested different notions of appropriateness of accounting presentation. They were at odds with the presumption that accounting experts could establish proxies of prices in ideal financial markets.

However, banking representatives remained short of providing conceptually satisfying arguments to match the conceptual power of the financial economics model that supported the fair value notion. In employing the notion of fair value, regulators were seen to align themselves with categories of risk derived from financial economics and to immunize themselves against intervention by banks. Meanwhile, behind the seemingly technical issues towered competing claims to the credible construction of accounting measures of risk by two bodies of knowledge: accounting and banking. In claiming theoretical rigor, the notion of fair value effectively deferred the issue of reliable measurement. Despite the criticism of banks and the subsequent difficulties in diffusing the guidance, the accounting debate gradually garnered more support for establishing fair value and thus representing 'reality as it really is'.

CHAPTER FIVE:

Debating the meaning of accounting

Debating the meaning of accounting

Abstract

In a Discussion Paper published in July 1996, the ASB anticipated some of the conclusions that were contained in the IASC's Steering Committee Discussion Paper of 1997. The ASB proposed to measure *all* financial instruments, including a firm's own debt, at current value. The Discussion Paper further suggested reporting holding gains and losses on fixed-rate long-term instruments in the ASB's second performance statement, the Statement of Total Recognized Gains and Losses (STRGL). The structure of the debate following the ASB's publication reveals the considerable resistance these proposals faced. Conflicting notions of appropriateness about reflecting changes in interest rates structured the ASB debate. These notions clustered around implicit models of the reporting entity. The models were associated with the meaning given to accounting representations and were seen to inform notions of appropriateness regarding the construction of certain financial risks in financial statements. Within the regulatory debate on financial instruments, a model of the reporting entity supporting traditional meaning of accounting was challenged by another model to reflect more of 'what the world does to the firm'.

Introduction

> *I think it's a great time to be an accountant, provided you are young. I think if you are an accountant towards the end of your career, it must be hell. Because your world is falling apart, the world is being ... dismantled in front or your eyes.*[198]

In July 1996, the U.K. standard setter published a discussion paper on 'Derivatives and Other Financial Instruments' (ASB 1996), which was to further dismantle the world of traditional accounting. Some conclusions of this paper were taken up in the 1997 Discussion Paper by the Steering Committee of the IASC (1997a). Eventually, the IASC paper became regarded as *the* seminal document to revolutionize thinking about financial instruments.

[198] Interview A, January 1998.

Meanwhile, some of the IASC's later notions of appropriateness to reflect effects of future events and thus to construct accounting representations of financial risk had already been considered in the ASB paper. The ASB's Discussion Paper became the first official document by a standard setting body to propose measuring *all* financial instruments - not just derivatives and hedging instruments - at *current value* and to recognize *all* gains and losses, whether realized or not. While it anticipated some of the IASC's conclusions, it was construed as a more general contribution to the international debate on financial instruments:

> *We were also aware that other countries around the world were beginning to talk about financial instruments - the IASC, the FASB in America, Canada, were obviously very interested - and we wanted to be part of that international debate. And we worried about this issue, perhaps more than others. If we could get an internationally agreed solution, it would be helpful for the large companies dealing in global markets. And ... we wanted to contribute to the international debate, so we had to think about the issues. I think, for all those reasons we've decided to take the project on. And we actually started to put it back in 1995 ... when we looked back and we said this is now a formal project, rather than just monitoring what other people were doing. ... We started at about the time that E48, the international exposure draft was being considered. And ... the IASC Board ... was considering whether to turn it into a standard. And we came onto the scene about that time. And we had some serious reservations with E48. So we started this project in a rather unusual way in telling IASC that we had reservations about E48 and didn't think they should turn it into a standard. In fact, they took account of those comments. Not only that, but they didn't turn E48 into a standard. ... Yes, and then we picked up these issues in our own discussion paper.*[199]

The international debate on financial instruments in the mid-1990s was characterized by the increasing involvement of the G4 group of English-speaking standard setters. Initiated by Tweedie, the Chairman of the ASB, in 1993, this group shared ideas and worked together on a couple of projects (Street and Shaughnessy 1998).[200] In June 1994, the intervention of this group of standard setters was crucial for bringing the IASC project to a halt. One year later, in June 1995, IASC came to issue only the disclosure and classification section of the proposed guidance in E48 as a separate disclosure standard IAS 32. At the same time, with its subsequent Discussion Paper, the ASB positioned itself more firmly in international

[199] Interview P, August 1998.
[200] The G4 included the standard setters from Australia, Canada, New Zealand, United Kingdom and United States.

debate that had hitherto been shaped by the IASC and the FASB projects. The paper itself partly emanated from the collaborative effort under the G4 umbrella to deal with representation of effects of future cash flows (Johnson 1994).

The regulatory position of the ASB by the mid-1990s was particular. It became increasingly seen to successfully fight a severe off-balance sheet and creative accounting crisis in U.K. financial reporting (Tweedie and Whittington 1990; Smith 1992; Shah 1996; McBarnet and Whelan 1999). New standards addressing accounting for capital instruments (ASB 1993b) and accounting for transfers (ASB 1994) had been published. These standards were seen to establish new ways to represent the substance of financial contracts. As a response to creative accounting, the fight of the ASB was seen driven by an attempt to reduce the scope for management discretion in financial reporting. As illustrated by the ASB's Discussion Paper, this attempt to reduce the scope for management discretion also came to shape notions of appropriateness of accounting problems and solutions in the broader regulatory debate on financial instruments.

In contrast to the emerging guidance in the IASC and the FASB projects, which referred to *fair value*, the Discussion Paper by the ASB came to rely on the notion of *current value*. As was argued by the ASB, current values allowed constructing accounting representations of financial risk, as they encapsulated the risk-adjusted worth of contracted future cash flows. Current values were thus seen to be:

> ... the best number for predicting future cash flows since they represent an up-to-date encapsulation of the worth of the contracted future cash flows. They reflect the market's current assessment of the amounts of the contracted cash flows, discounted to reflect both current interest rates and the risk that the contracted cash flows will not occur.[201]

Without defining current values in more detail, the ASB's Discussion Paper employed the notion of *current value* in a way similar to the way the FASB and the IASC came to refer to *fair value*. An appendix to the ASB's Discussion Paper provided some examples as to how current values might be estimated that were close to the guidance in SFAS 107 and IAS 32

[201] ASB (1996), p. 58.

for fair value.[202] While the ASB also appealed to the notion of *value to the business*,[203] the essence of its current value guidance seemed to be rather close to the notion of fair value on two important counts. First, it considered market value to be a subcategory of current value, an empirical approximation, and, second, it allowed considering *constructed* values based on valuation models. Like the notion of fair value, the notion of current value of the ASB came to serve as a panacea for constructing representations of financial risk similar to those that the notion of fair value was seen to enable:

...

> (c) in the absence of a market price, a quote may be obtainable from a broker or the counterparty. Alternatively, where the entity regularly acquires or originates similar instruments, current prices for those similar instruments may be used (this is most likely to be the case where the entity is a financial institution).
>
> (d) valuation techniques, including discounted cash flow analysis and option pricing models (such as the Black-Scholes model and binomial models). Such models require certain assumptions to be made (eg the use of the Black-Scholes option pricing model involves the assumption of a constant volatility for which a reasonable estimate is required).[204]

As discussed in the previous chapter, the emerging visibility of financial risks relied on shifting notions of appropriateness of what accounting can and should represent. The ASB's Discussion Paper suggested moving from a mixed measurement model for financial instruments to a more consistent current value model. The notions of appropriateness supporting this realignment aimed at reducing the scope for management discretion and on a conceptualization of financial instruments as separable contracted cash flows that could be reliably measured. Despite the novelty of some of the proposals contained in the discussion paper, the ASB received considerable support for some of its suggestions. Some of the

---

[202] The ASB later came to criticize the notion of fair value in the context of the JWG. In reference to its conceptual framework, the ASB rather advocated the deprival value concept (the lower of current replacement cost and recoverable amount), that "has been advocated by a wide range of academic, professional and public sources. [FN: Familiar examples are the Sandilands Report (1975) and Professor David Solomon's Guidelines for Financial Reporting Standards (1989).]" Proposed 'Statement of principles for financial reporting' (1995), par. 5.22.

[203] The concept of value to the business was promulgated by the Sandilands committee; it was equated with the amount of the loss, which would be suffered by an entity if the asset were to be lost or destroyed (Robson 1994c; Davies et al. 1997, p. 75).

[204] ASB (1996), Appendix, p. 3.

underlying notions of appropriateness were not universally shared however and some of the ASB's conclusions invoked considerable opposition.[205]

The ASB's Discussion Paper raised particular concerns by the proposal to value a firm's own long-term debt at current value. Many respondents were seen themselves as holding these instruments to maturity and did not consider it appropriate to report transient value changes of long-term liabilities as part of their financial performance. These concerns were to be discharged somewhat by the ASB's proposed reporting of transient value changes resulting from holding long-term debt in the Statement of Total Recognized Gains and Losses (STRGL) rather than in the profit and loss account.[206]

Most of the written comments that the ASB received, entailed disagreement regarding the proposed treatment of long-term debt. The arguments for and against current value measurement of long-term debt seemed to cluster around two sets of premises, which informed different understandings about the relevance of changes in interest rates for financial reporting. Supporting different notions of appropriateness of what accounting can and should represent, they attributed conflicting relevance to 'what the world does to the firm'[207] for financial reporting. To the degree that the relevance was grounded in different conceptual premises, the regulatory debate became structured by the different meaning attributed to certain economic events in accounting representations.

The different notions of relevance came to be supported by networks of experts and organizations and ideas about the purpose of accounting. In contrast to the significance of the meaning-reproducing networks, particular structural characteristics of contributors seemed to be less important. Audit firms were split on the issue as much as were preparers. In some cases, for example in the case of the Association of Corporate Treasurers (ACT), which is discussed in more detail below, commentators were unable to reconcile different

[205] Many contributors to the ASB debate were engaged in parallel the international debate of the IASC. Appendix A5 contains a more detailed analysis of this involvement of U.K. constituents in the IASC debate.

[206] A similar approach was suggested by (Edwards and Bell 1961) and later discussed by the Sandilands Committee.

[207] This expression has been attributed to Sir David Tweedie, the Chairman of the ASB.

notions of appropriateness held by their constituents. As a result they submitted contradicting responses as part of one comment letter.

By debating the significance of interest rate changes for financial reporting, the regulatory debate came to *reproduce* different meanings attributed to accounting. To the degree that premises implicit in contributions informed traditional notions of appropriateness, they were seen to reinforce the established meaning of accounting. To the degree that premises informed emerging notions of appropriateness, they came to challenge it. The debate did not reconcile the different incompatible sets of premises, as the 'compromise' position to report value changes in the STRGL was not accepted. Contributions either supported or rejected the ASB's premises and the underlying meaning they attributed to accounting. The structure of the debate thus shows the resistance new meanings given to accounting face in regulatory debates where incumbent notions of appropriateness are reproduced in reference to existing accounting guidance.

This chapter analyzes the premises underlying the arguments in the regulatory debate. It discusses the way the traditional meaning of accounting was being challenged by the ASB proposals. It shows how traditional meaning of accounting was drawn upon to counter the ASB proposals. The chapter relates the different implicit premises to ideal-type models of the reporting entity. These models can be seen to be associated with particular understandings about a firm's relationship with its economic environment.[208] The ideal-type analytical models of the reporting entity are empirically grounded in the ASB document, comment letters and additional interview material.

The remainder of this chapter is organized as follows. First, the issue of accounting for long-term debt will be introduced using a simple example. Afterwards, the ASB proposal and its justifications are presented. This will be followed by a discussion of comments to the ASB Discussion Paper, leading on to a discussion of the implication that different notions of appropriateness have on the accounting debate. The chapter closes with some general

[208] In drawing on Axelrod (1976) and Teubner (1993), Paterson (1997) adapts the notion of 'cognitive maps' for bringing to the fore the deeply held assumptions underlying the regulatory process for developing health and safety standards.

comments about the shifting notions of appropriateness and the reproduction of meaning given to accounting in regulatory debates.

Long-term debt and models of the firm

This section illustrates those conceptual issues involved in measuring long-term debt that gave rise to the regulatory disagreement discussed in the subsequent sections. It does so with reference to a simple example. A firm takes on a straight ten-year loan agreement with a nominal amount of £100m and a *fixed* coupon of 8%. The coupon corresponds to the opportunity cost of debt for the firm's risk class at the date of inception and thus to the effective yield of the loan. At inception, the instrument will be accounted for as a long-term liability at the repayable principal amount of £100m. Under traditional accounting rules, this balance sheet amount will not change over the ten years.

Table 5.1: Assumed year-end interest rates

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
8%	9%	10%	12%	7%	6%	9%	10%	8%	7%

If rates of interest change, the *current value* of the loan may change. The current value may be constructed by discounting the contracted future cash flows at the prevailing rate of interest. To illustrate the change in current value we may assume the pattern of interest rates depicted in table 5.1. The rates are effective for the remaining period until maturity of the loan and consider the risk of the loan. At each point in time, a flat yield curve prevails and the risk profile of the firm is assumed to remain unchanged. The constructed current value of the loan at the end of each year would be the sum of the values of the cash payments discounted by the respective interest rate. For example, at the end of year four, the present value of the loan would be £(84m).[209] Applying the same calculation, we may construct end of year current values for the loan as plotted in figure 5.1.

[209] $V_4 = \frac{£(-8m)}{1.12^1} + \frac{£(-8m)}{1.12^2} + \frac{£(-8m)}{1.12^3} + \frac{£(-8m)}{1.12^4} + \frac{£(-8m)}{1.12^5} + \frac{£(-108m)}{1.12^6} = £(-84m)$

Figure 5.1: End of year current values for loan

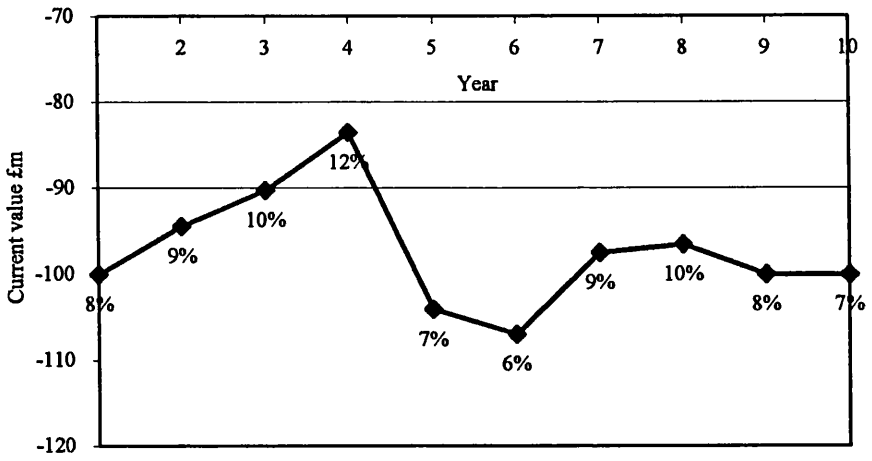


Figure 5.1 shows that the current value of the loan decreases as interest rates increase and *vice versa*. If the firm has the opportunity to buy back the loan, it could potentially realize holding gain or loss on the loan. For example, at the end of year four the firm could buy back the loan for just £84m. However, even if the firm did not have the opportunity to buy back the loan, it could achieve the same result by entering in a swap agreement. For example, a swap from fixed to floating rate where the fixed rate would be the initial 8% and the floating rate would be the current 12% would *yield* the firm about £16m.[210] Meanwhile, as suggested by figure 5.1 above, the value of the loan contract would invariably converge to £100m at the end of year ten. This would be case, even if the firm decided *not* to buy back the loan or to enter in a swap arrangement and irrespective of the structure of interest rates at that point in time.

The change in the *current value* illustrated in figure 5.1 gave rise to the question as to how the firm should account for long-term fixed rate debt when interest rates change. Are changes in interest rates relevant events that should be considered in accounting for long-term financial instruments?

Some of the early literature on economic concepts of income had grappled with this question

[210] $S_4 = \sum_{t=5}^{10} \frac{£(-100\text{m})(0.08-0.12)}{(1+0.12)^{t-4}} = £16\text{m}$

before it regained prominence in the current debate on accounting for long-term financial instruments (Hicks 1939; Paish 1977). Hicks considered different notions of income under the condition to maintain capital intact. In reference to Hicks' notion of income, Paish argued that whether to consider capital gain as income or not depended on personal preferences about how to strike the balance between capital value and future income yield (Macve 1984). For the case of an assets Paish concluded:

> Clearly, an individual owner of a security or other asset has maintained his capital intact if he is indifferent between his present combination of capital value and income yield, and a former combination ... Where, however, a corporation is concerned, its application is less obvious, since the indifference curves of the various shareholders may show great dissimilarities.[211]

As Paish argued, preferences determined the optimal mix between capital gain and income for individuals, while the optimal mix would be less obvious for corporations with different shareholders. More than fifty years after Paish published his paper, the same question resurfaced in a different form. This time, the question was whether changes in interest rates should be considered in accounting for long-term financial instruments and whether current value gains or losses on holding a financial liability should be realized in income. The regulatory debate remained split on this point. However, rather than reflecting individual preferences this split reflected different notions of appropriateness about reporting interest rates changes in accounting. On the one hand, The conceptual framework project by the ASB - still in progress in 1996 - suggested a balance sheet approach based on the definition of assets and liabilities (E&Y 1996). These notions of appropriateness were more in line with Paish's 'short-term speculator' that considered capital gains and losses as part of the current year's income. On the other hand, treating unrealized current value gains and losses resulting from changes in interest rates as income seemed to conflict with those notions of appropriateness that had traditionally provided meaning to accounting.[212]

The following discussion is based on a grounded analysis (Strauss and Corbin 1998) of the arguments put forward in the ASB's Discussion Paper and in comment letters and interviews

[211] (Paish 1977), p. 181.
[212] This dichotomy persisted despite the ASB's attempt to bridge it with its split of income in the STRGL and ordinary income.

with contributors.[213] The premises underlying comments for supporting or rejecting current value measurement of long-term debt supports the view that the debate became polarized according to two different sets of assumptions. These sets of assumptions informed different notion of appropriateness regarding the relevance of changes in interest rates for financial reporting. They may be synthesized in terms of implied models of the reporting entity. Two such models can be identified. In what follows, one model will be referred to as the 'firm as a venture' and the other as the 'firm as a portfolio manager'.[214] As *ideal-types* they can be characterized as follows:

Firm as a venture. The model of the firm as a venture primarily considers the core business activity of the firm. Financing is raised exclusively in support of the business activity to acquire more or less specific assets. In this model of the firm, there is little need to independently consider the performance of the treasury function. Traditional accounting principles such as matching and prudence are seen as appropriate filters for events that are relevant for balance sheet reporting. Financial risk is seen to be associated with future changes in cash flows rather than changes in current value.

Firm as a portfolio manager. In the model of the firms as a portfolio manager, the treasury operation becomes a business activity in itself that should be considered as part of the performance of the company. In this model, accounting is seen to appropriately represent events that change opportunities not only in the core business activity, but also in the financial markets. These events may be interest changes or currency movements to the extent that they affect the value of the business. Financial risk is seen to results from future changes in the current value of the total portfolio of financial assets and liabilities.

As they are characterized here, these models remain ideal-typical. Contributions to the ASB debate usually referred to selective aspects of these models. Meanwhile, the debate on long-term debt shows how changes in interest rates that remained irrelevant for the 'firm as a

[213] This grounded analysis relied on the software tool Atlas/ti.
[214] The corresponding ideal-types referred to by Paish were 'short-term speculator' and 'conservative rentier'. These characterized different sets of assumed preferences of individuals. The models discussed here are different as they refer to conceptualizations of the reporting entity.

venture' became relevant under the model of the 'firm as a portfolio manager.' In this sense did accounting for fixed-rate long-term debt become an issue for which notions of appropriateness corresponded with different models of the firm.

The following section discusses in some more detail the proposal by the U.K. standard setter (ASB 1996) for reporting changes in the current value of fixed-rate long term loans. The subsequent section considers the premises underlying the comments to this proposal and related interview material. Taken together, these two sections illustrate in more detail how the arguments for and against a particular accounting treatment came to appeal to the two above models of the firm to justify their position in the regulatory debate. They also illustrate how the regulatory debate came to challenge and reproduce the meaning given to accounting representations.

Balancing act of the standard setter

This section considers the premises on which the ASB's Discussion Paper rested. The Discussion Paper, published in June 1996, resulted from the elaboration of the ASB's comment letter to the IASC's Exposure Draft E48. Between May 1994 and June 1996, the ASB came to work on its own recognition and measurement criteria for financial instruments including long-term debt in which it set out to include all financial instruments. Drawing up the paper involved a broad network of experts, organizations and ideas:

> *But we went to talk to a whole variety of people, from accountants to users, prepares of accounts and some academics. And we said ... a basic question was 'what are the problems with financial instruments? And what do you think the potential solutions are?' And we had a series of about twenty or thirty of those meetings back ... I suppose it was actually late 1994 or early 1995. And from that, we ... gleamed what we thought what the issues were and how we might proceed. And then we had a whole series of board discussions culminating in the discussion paper in 1996.*[215]

In a series of meetings with experts and in the ASB board discussions, notions of appropriateness of accounting problems and solutions emerged. A dominant requirement for accounting guidance in the U.K. had come to be the requirement to eliminate management

[215] Interview P, August 1998..

discretion. It was shaped by the experience of off-balance sheet finance and creative accounting in the late 1980s (Tweedie and Whittington 1990; McBarnet and Whelan 1991; Smith 1992). The initial drafting process was a delicate balancing act between traditional accounting concepts and full current value measurement for financial instruments. One of ASB's external consultants, who personally favored a broader application of *market* values, characterized the balancing act of the ASB as follows:

> *The Accounting Standards Board ... felt that there must be some sensible intermediary position where certain of the instruments were market-valued, because they were derivatives and difficult and dangerous, and certain other things like long-term debt. ... And they tried over a period of two and a half years to work out a system, which was incapable of being abused, that would correctly portray everything you reasonably wanted to know about a company. But didn't drag people into something, which later would be difficult to sell ... So, it is a bit like saying that you are going to be moderate in the amount you drink. ... It's much easier to abstain completely than to try to be moderate.*[216]

ASB's notions of appropriateness suggested limiting the scope of management discretion in accounting for financial instruments. Keeping financial instruments at historical cost and allowing hedge accounting to defer gains and losses on hedging instruments was seen to give management too much discretion. On the other hand, opening the Pandora box of current value measurement for financial instruments was seen to stir associations with the current cost accounting debate fifteen years earlier (Tweedie and Whittington 1984; Robson 1994c; Robson 1994b; Tweedie and Whittington 1997). However, any 'halfway house' between a mixed model with historical costs and current values depending on the intended use of the instrument, as suggested by the IASC in E48, was seen not to provide a viable basis for accounting guidance either. Over time, the ASB thus came to converge on the view that the proposed guidance on financial instruments should move away from historical costs, should abandon hedge accounting and should require current value measurement for all financial instruments. This 'solution' was seen to conform to regulatory demands to limit management discretion and 'cherry picking' as explained in the ASB's Discussion Paper:

> ... companies can manage reported profits by 'cherry picking' which gains and losses to realise. For example, in a 'bad' year instruments with an unrealised gain can be

[216] Interview A, January 1998.

> sold in order to increase reported profits. This is a particular problem for financial instruments since gains and losses on them are easily realised either directly (by selling the instrument or refinancing it) or indirectly (by using derivatives).
>
> ...
>
> Using historical cost gives rise to a need for hedge accounting to correct the anomaly that results where risk on an instrument that is measured at cost is mitigated by an instrument that is measured at current value. ...[217]

An important idea to strengthen the ASB's notions of appropriateness was that the growing sophistication of financial markets would increasingly allow easy replication of most financial instruments, even long-term fixed-rate debt. It was believed that their easy replication would make these instruments more akin to cash positions. Drawing on the idea of market replication, the ASB argued that in any mixed accounting model two portfolios with similar economic characteristics could be presented differently depending on their history.[218] To avoid *anomalies* in recognition and measurement of what was considered to be the same, ASB proposed that *all* financial instruments should be measured at current value. Furthermore, the ASB argued that 'derivatives can speedily transform the position, performance and risk profile of a company in a way that is not made readily apparent within the present accounting framework'.[219] Supported by these ideas, the ASB appealed to what was close to our ideal-type notion of the 'firm as a portfolio manager' in justifying why firms should reflect market values for financial instruments in their accounts:

> [The Board] has come to the view that, in the light of the recent growth of derivatives, the trend for companies to *manage risk actively on a portfolio basis* and the ease with which gains and losses on financial instruments can be realised, all financial instruments have to be measured at current value with all gains and losses recognised as they occur.[220]

The ASB's notion of what was at stake in the financial instruments project, and where to search for a solution, thus remained closely associated with this conceptualization of the reporting entity. The model of the 'firm as a portfolio manager', together with the conceived

---

[217] ASB (1996), p. 12.
[218] The example for this argument was a fixed rate bond that was replicated by a portfolio of a floating rate bond and a swap from floating to fixed rate, as discussed in the previous section.
[219] ASB (1996), p. 9.
[220] ASB (1996), p. 17, emphasis added.

similarity of different instruments in terms of future cash flows, were at the heart of arguments to justify its conclusions.

> ... the distinction between a derivative and a non-derivative is sometimes difficult to draw. Both are essentially contracts for future cash flows and instruments that are traditionally thought of as non-derivatives may have cash flows that are very similar to those of instruments traditionally thought of as non-derivatives ...[221]

As financial instruments became seen as contracts for future cash flows, it became more difficult to distinguish traditional from derivative instruments. Resolving this ambiguity while limiting management discretion, as the ASB demanded, was seen to require treating all instruments the same. Long-term debt thus came to be included in the current-value measurement proposal based on the perceived similarity it had with replicating portfolios that might include derivatives. The ASB argued that, as illustrated above, fixed rate debt could be seen as equivalent in terms of cash flows and risks to floating rate debt plus a swap from floating to fixed rate. To the extent that firms and markets were seen to replicate portfolios of different financial instruments, any classification system relying on the distinction between derivative and primary financial instrument was seen as inconsistent. Furthermore, even traditional plain vanilla instruments could be seen to comprise of a portfolio of embedded instruments. For example, long-term debt often included an option for early redemption apart from its explicitly contracted future cash flows. This option was a derivative and could be of considerable value.

One important characteristic that all financial instruments were seen to share was that they rapidly changed their value in response to changes in market conditions beyond the control of the reporting entity. Market events were seen to affect the financial position of firms and, irrespective of management intent, represented opportunities that could be either taken or lost. This was the case, even if firms passively kept long-term fixed-rate loan agreements until maturity and repaid the full principal amount. To the extent that they were construed as the same, *all* financial instruments, assets and liabilities alike, appropriately needed to be measured at fair or current value to capture the financial risk they were exposed to.

---

[221] ASB (1996), p. 64.

Meanwhile, the ASB also discussed whether to exempt those firms from the proposed current value requirement that never considered the opportunities and risks associated with current value changes of long-term debt. As some experts involved in the ASB's deliberations had pointed out, certain firms would not consider current value measurement of long-term debt as meaningful. In discussing this point, the Board came to engage similar ideal-type models of the firm as the ones introduced above: it distinguished between a 'simple' and a 'sophisticated' firm. The 'simple' firm can be seen to correspond to the above model of the 'firm as a venture' and the sophisticated firm can be seen to correspond to the 'firm as a portfolio manager':

> Historical cost could be used by a 'simple' company that held its borrowings to maturity and used only straightforward derivatives (eg interest rate swaps) as one-to-one hedges of its borrowings or investments, never selling them before maturity. Conversely, a 'sophisticated' company that actively managed risk by buying and selling financial instruments in response to market movements would account for *all* its financial instruments at current value.[222]

However, the ASB rejected the distinction by type of firm for several reasons. The most important seemed to be the lack of verifiable criteria for distinguishing a 'simple' firm from a 'sophisticated' firm without relying on management intent. The notions of appropriateness shaped by the ASB's mission to limit management discretion and to apply 'universal rationales' were also reflected in the following comment:

> *I have a lot of sympathy with that. But I can also see that ... you can't completely hand over to management the ability to say, well this is how we want to show it. It has to have some kind of universal rationale not just the particular rationale of this particular management.*[223]

However, the ASB also appealed to behavioral consequences resulting from introducing a distinction between sophisticated and simple firms. In particular, it was argued that a distinction between simple and sophisticated firms could discourage 'simple' companies to engage in active treasury management, as explained below:

> *So we tried various ways of having dividing lines. We proposed initially to our consultants that we would have a dividing line saying 'if you trade these things*

[222] ASB (1996), p. 13, original emphasis.
[223] Interview P, August 1998.

actively then this is what you must do.' And the consultants said no you can't use that, because if you do what you are ... what you'll do is you will have an artificial barrier. That will create an accounting penalty if people start doing the right thing, because company treasurers and so on were saying: sometimes you do need to begin to trade these things. There are real opportunities, not necessarily to take on more risk, but even to reduce risk. Sometime you have to do these things and ... if you impose that kind of penalty, people will hold back from doing what they want to do.[224]

Notions of appropriateness emerging in the tightly knit debate leading to the ASB's Discussion Paper came to be supported by a supporting network of experts, organizations and ideas. These experts and the ASB came to rely increasingly on the model of the 'firm as a portfolio manager'.[225] In contrast, the model of the 'firm as a venture', under which firms were seen to pay limited attention to the treasury function and to consider specific financing in relation to specific assets, became seen as less representative of the construed 'reality':

It's true that you do have some kinds of project finance, where it [assets and liabilities] is very obviously tied together. But then you have a whole spectrum moving out from that, where the relationship to particular assets gets more and more remote. And where would you draw the line? It's very difficult. And I can remember in foreign currency translations, years ago, when that was being debated, some people felt, well, you could attribute your equity finance to your fixed assets and your loan finance to your current assets. So that was just for a guideline, you know it was really a bit of nonsense. So I think you have got to ... you got to produce a final standard that is based on reality, rather than on just a convenient kind of groupings of things.[226]

Moving to a more consistent use of current values for the separate valuation of assets and liabilities when these values were reliably measurable became increasingly seen as appropriate in order to make visible the 'reality' of market opportunities. Meanwhile, 'reliably measurable' was not to mean that current values had to be available in reference to empirical market transactions. It was seen to be sufficient to be able to construct current values in reference to valuation models. The attempt by the U.K. standard setter to introduce current valuation for all financial instruments received support from the idea, expressed in its proposed statement of principles, that accounting should move towards a more consistent application of current values:

---

[224] Interview P, August 1998.
[225] The ASB suggested though to exempt non-public companies from the provisions of the proposed standard.
[226] Interview P, August 1998.

> The Board ... believes that practice should develop by evolving in the direction of greater use of current values to the extent that this is consistent with the constraints of reliability.[227]

As discussed in chapter four, constraints of reliability were seen to disintegrate as a result of a virtuous circle that made the measurement 'less of a problem' in the future. Over time, the requirement to provide current value information was expected to lead to the development of more reliable measurement techniques. Furthermore, the idea that financial markets would develop in such a way as to allow smaller entities to participate in sophisticated financial instrument transactions received increasing plausibility in the ASB debate:

> *I suspect that it won't be that long before smaller companies do start doing these things. I mean banks will see the opportunity of selling derivatives to small companies. A small company that is facing very high interest rates might well want to swap into variable rates. And that will float down with the market and then get into lower rates at the bottom of the market, depending on its position.*[228]

Nevertheless, the ASB did not consider it appropriate to apply the current-value measurement model in all its possible consequences for the income statement. While valuation differences of most financial instruments were to be recognized in the profit and loss account, the ASB considered an important exception to this rule. It suggested that it would be '*in*appropriate' to report holding gains and losses on the revaluation of fixed rate long-term debt as part of income. Rather, the ASB proposed reporting both realized and unrealized changes in the value of these instruments, resulting from changes in interest rates, in the Statement of Total Recognized Gains and Losses (STRGL). Irrespective of interest rate changes, the cost of finance as shown in the profit and loss account was thus to be calculated at an effective yield to maturity, that is, on a historical cost basis. This proposal had the effect that, despite value changes being reported on the balance sheet, fixed rate borrowings would result in historical fixed interest charges in the profit and loss account thus isolating the earnings figure from interest rate volatility. Any volatility arising from changes in interest rates was to be absorbed in the STRGL:[229]

---

[227] ASB (1995), § 5.38.
[228] Interview P, August 1998.
[229] A seemingly technical but important point is that the ASB failed to explain how valuation changes that resulted from changes in interest rates were to be separated from changes that resulted from changes in credit risk.

> However, the Board believes that it would be wholly *inappropriate* for all gains and losses to be reported in the profit and loss account. There are two main reasons for this. First, some gains and losses, such as those on fixed rate borrowings, are clearly of a different nature form the results generated by the entity's ongoing operations and it seems right that they should be reported separately. The second reason for not recording all changes in value in the profit and loss account is that, for borrowings, this might be thought to imply that fixed rate borrowings are 'risky' (since their value varies with interest rate movements) and floating rate borrowings are 'risk-free' (since their value does not vary with interest rate movements). At least for a non-financial institution, this is not always the case.[230]

These justifications for treating holding gains and losses on fixed rate instruments differently than gains and losses on other financial instruments suggests that the ASB's Discussion Paper was straddling conflicting notions of appropriateness. It did so in an attempt to split 'what the world does to the firm' from other components of performance. The ASB came to appeal to different notions of appropriateness for the balance sheet and the performance statement. For the latter it came to suggest a classification closer to the 'firm as a venture' while its proposal for balance sheet classification relied on the model of the 'firm as a portfolio manager'. For performance measurement, the ASB proposal came to associate certain current value changes with external factors rather than with the firm. The appropriateness of this selectivity was justified in reference to the representations of financial risk. To consider fixed rate debt as 'risky' or 'risk-free' depended on the meaning given to the accounting measures of performance. The special treatment granted to long term debt suggests that the ASB considered firms as constructing interest rate risk differently than, for example, financial risk arising from defaulting debtors. The first came to be associated with events beyond the control of the firm. Although reported on the balance sheet in line with the perspective of the 'portfolio manager', performance guidance thus appealed more to the model of the 'firm as a venture'. This model would disregard interest changes as performance, but associate loss on default of debtors with the firm's decisions to grant credit and thus appropriately account for it by provisions that were reflected in the bottom line.

[230] ASB (1996), p. 17, emphasis added.

Firms as 'ventures' or 'portfolio managers'

Many commentators suspected the ASB document to be just another vein attempt to introduce current cost accounting and framework notions of assets and liabilities into U.K. GAAP through the backdoor of a technical accounting issue. To many practitioners the ASB's attempts to introduce full current value measurement 'smacked' of 'academic ideas' and criticized them for their assumed impracticality. The recommendations of the ASB's Discussion Paper created particular irritation with respect to the treatment of fixed rate long-term debt. Even commentators that were sympathetic to the ASB's general tenet came to disagree with the Board's seemingly inconsequential classification of interest rate events for the position statement and the statement of performance.

A closer look at the debate shows that even the notions of appropriateness for the balance sheet associated with the model of the 'portfolio manager' were far from generally accepted. They rarely permeated and hardly dominated the regulatory debate. Neither did these notions seem to become easily stabilized as new paradigms of accounting. They rather triggered considerable resistance.[231] Meanwhile, the conceptual resistance to the new notions of the 'firm as portfolio manager' in the case of financial instruments hints at more general difficulties that new notions of appropriateness face in view of strong incumbent notions of appropriateness.

The traditional accounting classifications of financial instruments and hedge accounting were seen to render support to incumbent notions of appropriateness closely associated with the model of the 'firm as a venture'. At the same time, the model of the 'firm as a venture' may be seen as rendering support to the traditional accounting classifications in use. Thus, notions of appropriateness associated with the model of the 'firm as a venture' were being reproduced by reference to professional classifications in use. Attempts to introduce variations in meaning given to accounting appeared to face the dual task of having to present workable accounting solutions as well as shifting the incumbent meaning given to

[231] This resistance seemed to follow similar fault lines as the resistance to introducing the conceptual framework in the U.K.

accounting in the regulatory debate.

This section illustrates the conceptual resistance that the proposals by the ASB faced. It does so by analyzing comment letters received by the ASB in response to the Discussion Paper. The analysis focuses on the way contributions came to appeal to the two ideal-type models of the firm in justifying their support and criticism, based on 66 public letters received by the ASB. Comment letters were coded according to the structure and premises of their arguments. Based on this coding, contributions were classified according to the two ideal-type models of the firm: the 'firm as a portfolio manager' and the 'firm as a venture'.

Table 5.2: Level of support for ASB's proposals on current value measurement

Report all financial instruments at current values?	**No support**	**Qualified support**	**Full support**	**All**
Number of commentators* and percentage share of class	32	13	15	63
Of which classified** as:				
Firm as a venture	27	1	2	30
Firm as a portfolio manager	-	5	7	12

* Including three comment letters that do not comment on fair valuation. Two letters are split into two separate responses; one replicate letter is omitted.

** Ideal-type second order categories derived from a grounded analysis of comment letters.

Venture model versus 'not full support':	Chitest:	0.00104
	χ^2-statistic:	10.756
Portfolio model versus 'full support':	Chitest:	0.002869
	χ^2-statistic:	8.889

As reflected in table 5.2, most written comments to the ASB paper rejected the proposal to measure *all* financial instruments at current value.[232] While most letters expressed agreement that trading portfolios should be marked to market, most commentators rejected current value measurement of long-term debt. Some of the commentators gave *qualified* support for fair valuation of *all* instruments - including long-term debt - contingent on, for instance, reliable measurement and successful distinction between credit risk and other financial risks.

[232] The selectivity of the accounting debate means that this level of disagreement is likely not to be 'representative' for the opinion of all constituents. Self-selection is a major methodological drawback for all studies of lobbying. Meanwhile, it is exactly this selectivity of the regulatory debate that makes studying the networking around notions of appropriateness interesting.

In those cases in which commentators elaborated their position, rejection and approval came to rely on arguments that premised on either of the two ideal-type models of the firm. In particular commentators that rejected the ASB proposal on long-term debt typically referred to arguments consistent with the model of the 'firm as a venture'. Many of those commentators approving fair valuation of all financial instruments including long-term debt appealed to arguments consistent with the model of the 'firm as a portfolio manager'. These sets of arguments are discussed in more detail below.

Firms as ventures

> *One of the main concerns that came out of our U.K. discussion paper was about valuing fixed rate debt, an institute's own debt. And many companies told us that when they borrow they seek a match of the cash-flow they are going to get in from their operations, whatever they are making, widgets or ... whatever their core operation is ... that that would generate cash-flows. And they ... search for a financing structure that broadly matches those cash flows. So if those cash flows vary very little with interest rate moves, then they borrow mainly at fixed rates. If those cash flows vary with interest rate movements, perhaps because of the inflation expectancy ... then they would like to borrow more at variable rate. And they see, when they got in this process that they got the right 'risk-free' matched financing structure. ... And therefore they don't want the gain and losses from debt coming through.*[233]

This comment by a member of the ASB characterizes the way many commentators in the course of the ASB's deliberations came to refer to the venture model. Contributors appealed to matching assets and liabilities so that cash flows from asset instruments were 'to meet the liabilities incurred by the business' and *vice versa*. This matching was also seen to be at the core of hedging. The experience of these firms was said to be that 'financial instruments are primarily used by industrial and commercial plcs to protect assets, cover liabilities or protect income streams.'[234] Under the perspective of such matching, any 'arbitrary' measurement of assets or liabilities at a balance sheet date was seen to be irrelevant to shareholders. It was not likely to provide a relevant measure of risk, 'as any value calculated at an arbitrary date ... would represent the liquidation value'[235] only.

---

[233] Interview P, August 1998.
[234] Comment letter by Midlands Industry Group of Finance Directors, 8 October 1996.
[235] Comment letter by Airtours, 31 October 1996.

Furthermore, commentators in line with the model of the 'firm as a venture' argued that if one were to follow the ASB, 'the balance sheet would contain a mixture of current and historical values.'[236] This would create 'inconsistencies on the balance sheet such that fixed assets (at historical cost) will be matched against the borrowings (at current value) used to acquire those assets.'[237] In consideration of the inconsistencies that would arise in the balance sheet 'there is no justification for singling out this particular area'[238] for moving away from the historical cost concepts. This was seen to be unjustified as the same 'financial price risk may exist in non-financial assets or liabilities, or anticipated cash flows.'[239]

Commentators appealing to these notions of appropriateness did not share the ASB's concern to abandon historical cost accounting for financial instruments, apart for those instruments that were kept for trading purposes. They did not conceive any 'demand for a change'[240] or a need to abandon 'the well-established accounting concepts of prudence and matching.'[241] Rather, to include long-term debt at current value on the balance sheet seemed to them 'inconsistent with the going concern or prudence concept on which accounts are based.'[242] It would render the balance sheet difficult to understand. U.K. GAAP was seen as firmly rooted in historical cost accounting. Moving closer to a blend of current value and historical cost model would make it 'more difficult ... to understand what accounts are showing and ... to have a robust conceptual framework'.[243] Instead, some commentators presumed a quasi-functionalistic demand for the existing system: because the historical cost model had evolved in its particular way 'there remains considerable inherent logic for it'.[244] The traditional notions of appropriateness were seen to receive support from incumbent practices of considering liabilities as financing assets according to the model of the firm as a venture.

---

[236] Comment letter by National Grid, 30 October 1996.
[237] Comment letter by Pilkington, 11 October 1996.
[238] Comment letter by ICI, 15 October 1996.
[239] Comment letter by ISDA, 4 November 1996.
[240] Comment letter by British Land Corporation, 7 November 1996.
[241] Comment letter by British Petroleum, 28 October 1996.
[242] Comment letter by Marks & Spencer, 24 October 1996.
[243] Comment letter by Scottish & Newcastle, 28 October 1996.
[244] Comment letter by Eastern Group, 15 November 1996.

Those critical commentators rejected the discussion paper's general tenet that current value information 'would produce any useful information'.[245] Rather, they maintained that the kind of information required by the ASB would mean that 'the informed lay reader is likely to be completely confused'.[246] In particular where marking to market does not reflect the underlying economic situation, that is, long-term finance matches long-term assets, the ASB's proposals were seen to 'probably lead to confusion and misunderstanding on the part of users of the accounts'.[247] It was felt that accounts would become less transparent and that the proposals 'will serve to make financial statements as obscure and difficult for the layman to understand as most now find actuarial valuations of pension fund liabilities'.[248] The proposals would inappropriately complicate financial statements without serving users of financial statements. Under the model of the 'firm as a venture' reporting opportunity gains and losses arising from changes in interest rates was not seen as useful information, they were seen as not making sense.

Furthermore, to the degree that notions of appropriateness conformed to the venture model of the reporting entity to match assets with liabilities, critical commentators stressed the inappropriate performance reporting arising from the ASB's proposal. The proposed treatment of long-term liabilities and fixed assets was conceived to result in inconsistent performance reporting: 'The treatment recommended for variations in interest charges is inconsistent with the treatment of variations in depreciation charges following revaluation of fixed assets'.[249] As suggested by the model of the 'firm as a venture', it was felt that, whether or not the resultant profit or loss was being recognized in the profit and loss account, 'companies may be less inclined to borrow on a fixed rate basis as they will be concerned about the effect revaluation has on their Net Worth'.[250]

As discussed in the previous chapter with respect to the IASC's proposals, banks were among the most vocal critics. Banking representatives argued that they remained

[245] Comment letter by Building Societies Association, 30 October 1996.
[246] Comment letter by Camron, 6 November 1996.
[247] Comment letter by 100 Group of Finance Directors, 5 November 1996.
[248] Comment letter by Land Securities, 16 October 1996.
[249] Comment letter by Guinness, 25 October 1996.
[250] Comment letter by British Aerospace, 30 October 1996.

unconvinced that changes in current values were giving a useful measure of the performance of banks' non-trading activities. More meaningful was seen to be the accruals-based accounting: 'the existing accruals-based accounting for such business gives current margins and yields and allows users to assess these in the context of current market conditions'.[251] Non-banking commentators also argued that the performance of directors 'can only be fairly assessed by judging their actions, which were the historical costs the directors incurred in the actual transactions undertaken'.[252] The notions of appropriate performance reporting reflected in these comments suggest considering performance in relation to management's action, associated with actual transactions, rather than opportunities associated with potential transactions. This selectivity conformed to the model of the 'firm as a venture', which suggested constructing risk and performance in terms of net cash flows after matching asset returns with payments associated with liabilities. Income recognition appropriately depended on actual transactions rather than the 'imaginary figures' reflected in current values. In particular, gains and losses arising from regularly revaluing fixed interest debt held to maturity were seen to 'bear no relationship to the actual transactions undertaken by the business.' They should thus 'have no relevance, particularly in the context of a commercial/industrial company'.[253] As one of the (then still) Big Six firms stated:

> Most entities use long-term debt to finance part of their long-term operations, some choosing fixed rate debt (or using a swap) to eliminate the risk of future changes in interest payments. The market value of such debt, or changes in value, have no relevance whatsoever to the entity or the users of its financial statements if it does not intend to restructure or convert the debt so as to realise a gain or loss.[254]

Commentators' notions of appropriateness entailed that financial reporting had to reflect the way managers were making sense of the instruments in their operations. Namely, 'if financial statements are to represent faithfully the activities of a business, then assets and liabilities must be accounted for on the basis of the way in which they are used in that business'.[255] Therefore, 'it is only when a company is, as it were, 'trading' in its own

[251] Comment letter by British Bankers' Association, 4 November 1996.
[252] Comment letter by Mr. M. Davies, 19 October 1996.
[253] Comment letter by Slough Estates, 28 October 1996.
[254] Comment letter by Ernst & Young, 29 October 1996.
[255] Comment letter by London Investment Banking Association, 4 November 1996.

financing that the concept makes sense'.[256] The Institute of Chartered Accountants in England and Wales (ICAEW) therefore suggested to limit current-value measurement to firms, which had adequate treasury operations, that is, to firms whose management's notions of appropriateness conformed to what we came to call 'firms as portfolio managers':

> Whilst the ASB intends that the measurement proposals should only apply to listed and public interest companies, we believe that current values only provide relevant information where a group includes active treasury operations; the scope should preferably be defined on this basis rather that the existence of a stock exchange listing or public interest.[257]

Firms as portfolio managers

However, a number of commentators accepted the arguments put forward in the ASB's Discussion Paper. Those supporters that commented more specifically on the proposals noted the opportunities firms faced in modern financial markets and 'the ease with which companies can enter into, or close out, derivatives contracts'.[258] Some commentators even took a stronger view than the ASB. They argued that 'current values will form the basis of financial reporting to the capital markets into the next century and commend the Board for setting out a vision for an appropriate framework and stimulating the discussion'.[259] Notions of appropriateness for these commentators were informed by the ease with which gains or losses on financial instruments could be realized. The assumption that companies would consider prospective cash flows from financial instruments as akin to cash led them to 'support the view that financial instruments should be reported at current value'.[260] As suggested by the model of the firms as a portfolio manager, this entailed actively reflecting in the financial statements those opportunities that potentially existed in financial markets.

Some of this support was from regulators. For example, the U.K. Securities and Futures Authority (SFA) underlined their requirement to know the potential wind-up value of a firm, as opposed to following the traditional 'going concern' basis of preparing financial

[256] Comment letter by KPMG, 31 October 1996.
[257] Comment letter by ICAEW, 5 November 1996.
[258] Comment letter by Arthur Andersen, 30 October 1996.
[259] Comment letter by Price Waterhouse, 31 October 1996.
[260] Comment letter by Chartered Institute of Public Finance and Accountancy, 29 October 1996.

accounts. The SFA's notions of appropriateness drew on the model of the 'firm as a portfolio manager' to suggest the consideration of *exit* values of financial positions. The SFA concluded that 'using current values gives a more up to date picture of the financial position of the firm, enables a better informed assessment of the risk management capability of the firm and allows comparison of different firms' performance'.[261]

On the other hand, most of those commentators whose arguments were more congruent with the model of the 'firm as a portfolio manager' rejected ASB's proposed reporting of some holding gains and losses in the STRGL. For instance, they argued that 'early termination of swaps and long-term debt should result in a charge to the P&L account, not the STRGL'.[262] As implied by the model of the portfolio manager, the gain or loss should be considered in the same way as an advance payment or a receipt of interest. As the model of the 'firm as a portfolio manager' implied a broader notion of financial risk and performance, even events beyond the control of the firm were associated with decisions and the responsibility of treasury management. In this sense, not to hedge was seen as much as a decision as to hedge. Gains and losses resulting from interest rate changes were regarded as part of performance, rather than of 'what the world does to the firm'. It was considered appropriate to let 'everything passing through the profit and loss account with appropriate disclosure and explanation of those profits/losses having a significant impact on the overall profit of the reporting entity and of any unrealised profits included which are not available for distribution'.[263] Under the notions of appropriateness that were associated with the model of the 'firm as a portfolio manager', it was argued that 'the ASB approach to the accounting for the gains and losses will negate the benefit of the full current value approach for all financial instruments'.[264]

Even if the ASB was determined to keep the second performance statement, some commentators proposed a more consistent use of the STRGL. For example, they suggested having all holding gains not only on financial instruments pass through it: only 'trading and

[261] Comment letter by the SFA, 19 November 1996.
[262] Comment letter by the Association of Corporate Treasurers, 11 November 1996.
[263] Comment letter by London & Manchester, 21 October 1996.
[264] Comment letter by Unilever, 30 October 1996.

speculation gains and losses should be reported in the profit and loss account. Holding gains on financial instruments are not after all different to the gains arising on property and investment property'.[265] While some of these commentators shared the ASB's notions of appropriateness, they came to question why the ASB did not require more comprehensive current value measurement: if 'measuring derivatives and other financial instruments at current value is the correct approach [it should also be] correct for all assets and liabilities'.[266]

Overall, the notions of appropriateness engaged by supportive commentators appealed to the 'firm as a portfolio manager', but demanded a more meaningful representation of effects resulting from financial market events in performance reporting. They supported the ASB's efforts to introduce current value measurement of financial instruments. However, they felt that the treatment of gains and losses resulting from interest rate changes had not been 'satisfactorily worked out'.[267]

Incommensurable models

The sets of premises that we analytically synthesized into two models of the firm appeared to inform incommensurable notions of appropriateness. The comment letter by the Association of Corporate Treasurers (ATC) provides an interesting example in this respect.[268] This comment letter contained a split response. One group of respondents approved current value measurement of long-term debt and the other group rejected it. The group of the ACT that argued *against* current value measurement of long-term debt provided the following explanation for their position:

> Those opposed to the use of current values argue that it is irrelevant, confusing and undesirable to measure financial instruments in this way when other balance sheet items are not treated in the same way. There are a number of potentially material technical issues on valuation which have not yet been addressed and in general it is felt that there is far too much subjectivity in much of the valuation process to produce

[265] Comment letter by Deloitte & Touche, 16 October 1996.
[266] Comment letter by Stakis, 12 August 1996.
[267] Comment letter by Tate & Lyle, 24 October 1996.
[268] The ACT is an independent professional association of financial managers in the U.K. providing seminars and a training program. The ACT also participates actively in regulatory debates within the UK.

reliable answers, for example, when market evidence is thin.[269]

This rejection of the ASB's proposal rooted in the understanding that representing interest rate events should not result in an asymmetric treatment of assets and those liabilities that were seen to finance them. This concern for matching financing with a particular set of assets and keeping the liability value congruent characterized the model of the 'firm as a venture'. According to the notions of appropriateness suggested by this model, reflecting opportunities available to the treasury function appeared to be less relevant. The perceived unreliability of the current value measure accorded with the reluctance to accept *constructed* values if they did not carry any meaning. Interestingly, the group of the ACT *approving* the current value measurement of long-term debt did not consider this point. They saw constructed present values to be 'less wrong' than a historical value:

> *And there was a classic case of a company called Queens Motels, which at one moment had a reasonably strong balance sheet and the next moment had collapsed and gone to the liquidators. Because somebody said this basis of valuing the balance sheet was hopelessly wrong, which indeed it was. The reason was that if you looked at historic cost accounts, these hotels cost a lot of money they had been depreciated in a sensible way. And if you wanted to build a new hotel, there was no doubt it would have cost you something rather similar to what was in the balance sheet. But the fact is that, if you did a net present value calculation on the bases of the room income, income by room at the expected occupancy rates, you could see that the company was basically bust.*[270]

The notions of appropriateness of what accounting can and should represent expressed in this example can be seen to reflect what we have stylized to be the model of the 'firm as a portfolio manager'. All firms, whether adopting an active treasury management or not, were seen to operate under unavoidable opportunities and threats in financial and other markets. In contrast to those who rejected current value measurement for long-term instruments, the treasurers approving ASB's proposals were considering performance more broadly. They saw treasury management as part of the firms' overall performance:

> *The most important thing is the discussion of what it is you are trying to do. The measurement of the performance or how well you have done. And there can be, in my opinion, no other criteria other than market values. And that applies all the way from short term derivatives operations to generic interest rate exposure, the overall costs*

[269] Comment letter by the ACT, 11 November 1996.
[270] Interview A, January 1998.

to the company of long-term debt. Because you need to evaluate the corporate not on what he has done, but also what he could have done and didn't do. You can't just look at one side without looking at the other.[271]

Even action *not* taken was seen to affect performance as it was changing the opportunities open to the firm. Our model of the 'firm as a portfolio manager' that considered exposures to financial markets as 'real' as profits from operations came to synthesize these notions of appropriateness. However, the same notions of what is 'real' led this group of the ACT to *reject* the ASB's proposal to use the STRGL to report holding gains and losses on long-term debt:

> There is concern that the STRGL is in danger of representing gains and losses which are in some sense second class ie. not real. Any gain or loss, properly recognised in the accounts, should be a real gain or loss adding to or subtracting from the economic value of the company. It is inappropriate to say that some gains are 'better' than others from an accounting perspective. Clearly equity analysts will wish to have sufficient information to judge whether or not a gain or loss occurred by accident, is sustainable, repeatable or reversible, but the STRGL should not be seen as a halfway house between profit and loss accounting and reserve accounting.[272]

For the group of supporters, a concern was to reflect the valuation differences as first class gains and losses and not to flush them through a 'second class' statement suggesting they were 'not real'. The 'halfway house' approach suggested by the ASB did not make sense to them. In other words, it did not seem to conform to their notions of appropriateness associated with the model of the 'firm as a portfolio manager'. The current value difference resulting from an interest event had to be considered as 'real' income or not, however, not as *something* in between. To accommodate this duality it was suggested to consider the STRGL more as a holding tank along the lines of the U.S. comprehensive income statement:

I believe the ASB is wrong on the role to be taken by the Statement of Total Recognized Gains and Losses. I think the concept should be the Statement of Total Recognized Gains and Losses is a holding tank, a holding tank into which profits and losses come at one time and later on go out again through recycling. ... And you can see how this is ... if you put all of the gains and losses on long-term debt and associated hedging instruments into the STRGL. ... If you do nothing, they will automatically recycle by the end of the period of the debt and its hedging instruments. If you repay the debt early, you will also recycle to zero, because you will take the cumulative Statement of Total Recognized Gains and Losses as of the start of the

[271] Interview A, January 1998.
[272] Comment letter by the ACT, 11 November 1996.

debt. And the difference between that and zero will be your profit or loss at termination of the debt. Because on a mark to market basis that will be the missing bit. So whether you let debt run to its natural turn or you repay it early the STRGL will always come down to zero difference.[273]

Meanwhile, the group of ACT members opposed to ASB's proposals along with their rejection of current value measurement rejected reporting valuation differences in the STRGL. However, according to their different notions of appropriateness, they provided different reasons for their rejection of the ASB's classification of performance:

> In general, only realized gains and losses should be reported in the P&L account, other than where this would not present a true and fair view. There are three main reasons why unrealized gains and losses should not be reported in the STRGL:
>
> - the words 'gain' and 'loss' are emotive and their use could deter businesses from taking sensible economic decisions
>
> - the user of financial reports is concerned to understand the risks business faces; the proposals treat risk as accumulated fact and confuse rather than clarify
>
> - taxation impacts are subjective and confidential, and, at this stage, have been ignored by the ASB.[274]

The first and second of these reasons considered the way accounting appropriately constructed representations of performance and risk. The third reason considered the 'economic consequences' related to taxation, which were seen to affect the reporting entity. All three reasons referred to the way accounting was seen to construct appropriate representations of what was seen to be 'real' according to the congruent model of the 'firm as a venture'. The way the firm's financial risk exposure and performance were constructed by accounting representations was seen to have real behavioral effects. Notions of appropriateness that did rely on constructing the firm as a venture thus genuinely rejected treating valuation gains and losses in the STRGL. The income volatility resulting from reflecting 'what the firm does to the enterprise' was seen to be beyond the control of the entity as a venture and thus deemed irrelevant.

The incommensurability of notions of appropriateness that we associated with the two

[273] Interview A, January 1998.
[274] Comment letter by the ACT, 11 November 1996.

stylized models of the reporting entity were also referred to in the comment letter by Coopers & Lybrand (now part of PricewaterhouseCoopers). While the comment by the ACT was split into two sections with regard to the proposed balance sheet treatment of long-term debt, the Coopers & Lybrand comment suggested more generally to adjust guidance according to the type of reporting entity. Coopers & Lybrand thus responded to the ASB's discursive distinction between 'simple' and 'sophisticated' firms which was seen to be based less on size or market capitalization but on the meaning given to the treasury function by management. Unlike the standard setter, however, the commentators from Coopers & Lybrand suggested that the distinction could be audited. They depicted the two models of the firm as follows:

> A 'simple' company would approach financing and risk-management in a more passive way. It might borrow long-term; and if that borrowing was fixed rate it might swap it into floating rate (or vice-versa). But having done so, it would not continue to monitor the situation actively. Clearly, it might well have no derivative activity at all. For a 'simple' company the market value of long-term instruments seems to us to lack relevance for both internal and external reporting purposes. A 'simple' company would continue to use the historical cost basis for financial instruments classified as fixed assets and for long-term borrowings and non-equity share capital. Unrealised gains (and losses) on these long-term debt instruments are not relevant, since, if held to maturity, they will reverse over the life of the instrument. Presenting them as real gains for a company that intends to hold the instrument to maturity could be misleading. ...
>
> However, a 'sophisticated' company would use current values for all financial instruments, including long-term investments, long-term borrowings and derivatives, with gains and losses recognised as they occur. We believe that for these companies (as explained above) current values are more relevant than historical cost and so we support the use of current values for all financial instruments by such companies.[275]

Coopers & Lybrand proposed to classify firms by the way they were seen to construct financial risk and performance in line with management's notions of appropriateness of what financial accounting can and should represent. As it was an elaboration of the distinction proposed by the ASB, this proposal illustrated the two ideal-type models of the firm discussed above. The 'simple' company corresponded to the model of the 'firm as a venture' and the 'sophisticated' company corresponded to the 'firm as a portfolio manager'. Depending on their type, firms were seen to engage different notions of appropriateness:

[275] Comment letter by Coopers & Lybrand, 28 October 1996.

And a company that is not in that very limited category [sophisticated] looks at this ... and looks at these changes and says, what on earth does that mean to me? I borrowed a hundred and I am going to repay a hundred, don't tell me all this nonsense. And a lot of companies are in that category. And this is where this all came from. You know they are not sophisticated in treasury matters. And they don't think ... this peak and this trough have no meaning to them, really. And so, to report it in the financial statements is somehow missing the point. ...

But ... it's easy to think of listed companies and think of the top 100. They are household names, they got big central staff and they can cope with all these things. We've got a lot of them ... you know; we are auditors of a lot of these companies. But we are also working with companies that are ... listed companies but they are still ... in a sense family companies. They are good at selling cars or something ... or whatever they do. And they are not good at this sort of thing. And they don't particularly want to be. And so it's ... it's not easy to ... even to cut it off at listed companies.[276]

They felt that a wholesale adoption of current value measurement for financial instruments failed to make sense for preparers. Their framing of financial risk, that is, how they associated external events with their performance, was seen to determine what was meaningful to them. Furthermore, the commentators from Coopers & Lybrand, like the commentators from the Association of Corporate Treasurers, remained unconvinced that the STRGL was the appropriate place to report valuation differences on long-term debt, for the 'simple' as well as for the 'sophisticated' company. They commented:

> We are not convinced by the proposal that some gains and losses on financial instruments should be reported in the statement of total recognised gains and losses. We believe that there is a good case for recognising all gains and losses arising as a result of changes in value of financial instruments in the profit and loss account. This would mean that unrealised gains on long-term debt instruments and borrowings arising as a result of interest rate movements would be treated in the same way as foreign currency movements and taken to profit and loss account.[277]

These two as well as the other detailed comment letters illustrate how arguments in the ASB debate were grounded in fundamental premises about the meaning of accounting. Different notions of appropriateness about representing certain types of financial risk, which we associated with models of the firm, were supporting different justifications. Under both models of the firm that we identified, the ASB's proposal to have all financial instruments measured at current value but to stop short of reporting resulting gains and losses as 'real'

[276] Interview O, August 1998.
[277] Comment letter by Coopers & Lybrand, 28 October 1996.

income was seen as inconsistent. Opponents of the current-value measurement model did not consider value changes resulting from interest rate fluctuations to be relevant at all. For many proponents of current value measurement 'what the world does to the firm' appropriately had to be reported as ordinary income and not in the STRGL. As suggested by the model of the 'firm as a portfolio manager', interest rate changes were seen as events that the firm had to manage, whether it thinks about them or not.

Discussion

> *I mean, this is why I do feel you can't have a debate about financial instruments in isolation, you have to go back to the very basic question: What do we draw up accounts for? What are we trying to show?*[278]

The issue of financial instruments emerged when off-balance sheet instruments and financial engineering were seen to challenge traditional classifications of accounting and traditional notions of appropriateness of what accounting can and should represent. With the rise of financial instruments projects, notions of appropriateness came to shift. The major standard setters came to embrace ideas from financial economics to make sense of what financial instruments were. Financial instruments became seen as sets of cash flows that, as the notion of fair or current value suggested, could be measured, even if they were not traded in liquid markets. These ideas, which became debated and gradually accepted among the experts closely involved in the project, came to change the way financial risk came to be constructed in terms of accounting. With these shifts, a new *model of the accounting entity* emerged. Under this model of the firm, standard setters came to consider as appropriate for accounting representation events that traditionally had been excluded from measurement, such as interest rate changes. A growing conceptual resistance against these notions formed. As discussed in this chapter, by the mid-nineties, the regulatory debate came to crystallize around conflicting notions of appropriateness informed by different conceptualizations of the reporting entity, which, like theological points of view, seemed to be impossible to reconcile:

[278] Interview S, August 1998.

You can't, you know, you can't change someone's mind on a religious point by argument. And I think fair value for financial instruments is just like that. I really do. And perhaps, you know, I mean, we are probably as guilty in that, you know. We have a point of view, which is that there are these big differences in what the business is. Whereas where the standard setters come from is, you know: a financial instrument is a set of cash flows. Why you've got it doesn't really matter it's still the same cash flows. I'm not sure you are ever going to get a meeting of minds between those two - what are essentially theological points of view.[279]

This chapter suggests that changing incumbent notions of appropriateness tends to be a slow and arduous process. It illustrates the idea that extant institutional arrangements supply the very criteria by which participants discover normative guidance.[280] The extant accounting constructs of financial risk supplied the incumbent notions of appropriateness. Only those effects of contingent future events that were associated with past action appropriately were to be included in income. As the traditional accounting model suggested - reinforced by present financial reporting practice - this excluded the effect interest rate events might have on long-term liabilities. By reproducing extant categories of appropriateness, the debate thus reproduced the meaning that was given to accounting representations. In this chapter, the premises informing the conflicting notions of appropriateness were reconstructed as models of the firm. Observing how arguments, implicitly or explicitly, referred to these models allowed mapping the intellectual positions that structured the accounting debate. It also allowed illustrating the resistance to structural shifts in the course of the project.

In the ASB's debate on long-term debt, the model of the 'firm as a venture' could be seen to inform notions of appropriateness that were resisting those notions that seemed informed by a model of the 'firm as a portfolio manager'. In the latter model, which was implicated in the ASB's Discussion Paper, but also in the IASC's Discussion Paper one year later, changes in interest rate were considered relevant for financial reporting. However, there was a considerable *conceptual* resistance to the proposals to consider the effects of interest rate changes on the balance sheet and in the income statement. More than eight in ten commentators *not* supportive of the current value measurement appealed to notions of appropriateness that matched the model of the 'firm as a venture' to argue their point. While

[279] Interview S. August 1998.
[280] Refer to DiMaggio and Powell (1991).

supporters of current value measurement elaborated less on their position, almost half of them provided a justification. Most of these justifications conformed to the model of 'firm as a portfolio manager'. Some commentators not falling into either one of the ideal-type categories explicitly appealed to the need to distinguish between types of firms. Like Coopers & Lybrand, they argued for limiting the scope of the proposed standard to certain types of firms, or to exempt firms from certain provisions based on what was had been referred to as 'sophistication' by the ASB.

The strong rejection of the proposal to report holding gains and losses on long term liabilities in the STRGL united supporters and opponents of current value measurement. This rejection illustrates the conceptual demand for consistency of the underlying accounting model. Meaningful financial reporting was seen to demand a consistent model of the firm and its economic environment. Depending on the model, events were seen to either affect performance or not, there was not to be something in between. Apart from the demand for internal consistency reconstructed in reference to the different models of the firm, it seemed that the proposed paradigmatic shift suggested by the ASB failed to find broader resonance in the accounting debate. While a full current value measurement system technically eliminated the need for hedge accounting, except for hedges of off-balance sheet items,[281] there was overwhelming support for retaining hedge accounting, even by supporters of a full current value system.

It remains to be seen whether the emerging notions of appropriateness associated with the model of the 'firm as a portfolio manager' will eventually establish a more permanent shift in the meaning given to accounting. The traditional accounting model appeared to reinforce the incumbent meaning given to accounting constructs, which we associated with the 'firm as a venture'. The traditional accounting model was justified by notions of prudence and conservatism and relied on matching of assets with liabilities in view of the considerable uncertainties in reporting consequences of future events. It was reinforced by accounting practice such as provisioning and hedging. As attempts to introduce new accounting

[281] Provided hedged items are measured at current value as well. Refer to appendix A4, in particular the cases of the IASC Discussion Paper 1997, E62 and IAS 39.

guidance had to shift incumbent notions of appropriateness, the debate became as much about the meaning of accounting as about accounting techniques.

Over time, as was explained in some of the interviews, subtle shift in the meaning given to accounting had taken place. Even some of the more critical commentators came to share the view that, despite conceptual and practical difficulties, financial accounting would eventually move closer to a current-value measurement system for *all* financial instruments. Most commentators, however, acknowledged that this process would require time. It was seen as a matter of slow shifts in the notions of appropriateness, of informing if not of educating users and the public. As one commentator remarked: '... this is fine, I mean, I'm all in favor of it. But it's a very gradual, very partially successful thing'.[282] The effort that was seen involved in shifting the notions of appropriateness corresponds with the observation that standard setters worldwide increasingly came to collaborate in areas that were conceptually contested. By strengthening their respective networks of ideas, experts and organizations, they came to garner wider support for their notions of appropriateness.

[282] Interview O, August 1998.

CHAPTER SIX:

Conclusions on the process of accounting regulation

Conclusions on the process of accounting regulation

The IASC's financial instruments project came to mirror what may be seen as a more profound change of style in international accounting regulation: an increasing reliance on conceptual foundations of accounting as well as a growing importance of international collaboration. Tracing the emergence of the network of experts, organizations and ideas that came to support the regulatory debate on financial instruments illustrates how conceptual premises and a tightly-knit network came to structure the regulatory debate. While the usual limitations of single case studies apply, this chapter attempts to pull together some wider-ranging conclusions from the material presented in the previous chapters. In reference to the analytical framework outlined in chapter two, this chapter also summarizes and elaborates theoretical aspects of the process of accounting regulation.

Notions of appropriateness

In her work on agenda issues in accounting regulation, Young (1994) illustrated the process of conceptualizing certain practices as accounting problems, which could be seen to be *appropriate* for standard-setting action. Rather than considering agenda formation as a response to political pressures or as a conscious effort by the FASB to promote its organizational survival, Young argued that the process of agenda formation largely involved conceptualizations of problems and solutions. For a non-accounting area of standard setting, Cheit (1990) draws similar conclusions. Meanwhile, he argued that the process of standard setting involved conceptualizing problems along with solutions. In contrast to the process of conceptualizing, the attempts to estimate probable costs and benefits were typically later steps. At the same time, the emergence of problems and solutions was seen to depend on conceptual preferences that were not arrived at in a deliberative fashion. Cheit (1990) saw these preferences to be more institutional than transient and not to be subject to bargaining or compromise. Rather, they acted as working assumptions that were rarely made the topic of discussions.

This research on the IASC's project on financial instruments brings to the fore some aspects of these structuring institutions of the regulatory debate that were rarely made the topic of discussions within the debate. We have referred to a meaning-reproducing network as the institutional structure that was seen to inform notions of appropriateness of problems and solutions. In what follows, we will first summarize and discuss some *intangible* aspects of the network that supported the international regulatory debate on financial instruments: the role of concepts and ideas in the framing of *problems* and the emergence of *solutions*. This discussion will be followed by a section that looks closer at the more *tangible* aspects of the network, in particular the involvement of organizations and experts. This concluding chapter closes with discussing some implications resulting from this analysis.

Appropriate problems

In chapter three, we reflected on the agenda formation in the early IASC project on financial instruments. In the course of the early 1980s, even before the project was underway, professionals and academics had come to address the uncertainty in accounting practice relating to financial contracts. However, until around 1985 (AICPA 1985; ICAEW 1985), these concerns did not become issues to require fundamental changes in the accounting framework. At the same time, changing expectations about the role of accounting were seen to emerge at its margins in areas such as banking regulation and at the interface between law and accounting. Regulatory concerns in these related areas came to challenge accounting and gradually gave rise to notions of accounting problems.

Initially, the 'mushrooming' challenges to existing accounting categories that were 'cropping up here and there' were dealt with in a piecemeal fashion. There were various attempts to frame, for example, hedge accounting within existing conceptual classifications and categories in order to maintain the consistency of the existing accounting edifice. However, establishing a regulatory agenda involved more than that. It involved the translation of challenges like 'off-balance sheet risks of banks', initially seen as a problem of banking regulation, and 'creative accounting', seen as a problem of defining ownership at the intersection between law and accounting, into accounting problems. It was not before

1986 that the various challenges came to be seen as having something in common that could be framed more broadly as *financial instruments*.

The notion of financial instruments allowed problematizing the *accounting* for financial contracts by alluding to the conceptual framework and constructing them as financial assets and liabilities. The notion of financial instruments allowed turning the various financial contracts into objects for regulatory initiatives and, importantly for the IASC, justifying an accounting project to deal with them internationally. Although initially unspecified, the notion of financial instrument was carrying a promise to represent the risks associated with innovative financial contracts within the realm of accounting. However, as discussed in chapter three, this promise involved considerable reworking of accounting premises and the IASC financial instruments project needed to mobilize allies in its support: experts and organizations, but also classification concepts and abstract ideas. Classification concepts, for example on hedging, and ideas about the appropriateness of the risks and rewards approach were drawn into the project from national regimes in particular from the parallel U.S. and U.K. debates.

The proposed scope decisions in the IASC's early financial instruments project came to delineate the possibilities of accounting in new ways. This redrawing of the boundaries of what financial accounting can and should represent was seen to affect claims to representation by other bodies of knowledge. They were seen to affect areas such as banking regulation and law, where concerns about innovative financial arrangement had first surfaced. They also affected representations of financial risks, which were resisted by bankers and life insurance firms. Meanwhile, in the course of the initially still fragile project, controversial scope decisions gradually became taken for granted, such as accounting recognition of *all* financial instruments. These emerging boundaries of accounting stabilized among the group of technical experts involved in the project on the conceptual basis that they allowed a coherent accounting representation of what came to be seen as the new reality of financial markets. The scope decisions received support from the experience with different instruments in the context of developed capital markets as well as the definition of financial instruments in the FASB's project on disclosure. However, as

these scope decisions established the accounting claim to representing the emerging reality of all financial instruments, they created the challenge to furnish the appropriate diagnostic tools.

As discussed in chapter four, the claims to representation of financial instruments resulting from the scope decisions were initially seen to be a simple matter of adjusting recognition and measurement guidance. However, the intricacies of recognition criteria for financial instruments came to challenge framework based accounting guidance and, as they were seen to be contingent on future events, increasingly came to challenge the traditional meaning of accounting as well. While recognition had come to rely on a selective assessment of measurable risks and rewards, it was gradually seen as more appropriate to consider *all financial risks* that entities were seen to expose themselves to by entering into contracts. The accounting for financial instruments thus became construed in terms of financial risk representations that would be less dependent on management discretion. While traditional accounting had relied on past transactions involving a physical correlate as appropriate events for prompting recognition, the expected effects of future events became increasingly seen as a more appropriate trigger for recognition.

Chapter five discussed how the appropriateness of accounting problems was grounded in specific models of the firm. With respect to the appropriateness of interest rate events, contributors to the debate resulting from the publication of the ASB' Discussion Paper were seen to appeal to different sets of premises giving different meaning to accounting. Different models of the reporting entity were seen to inform conflicting notions of appropriateness concerning the reporting of interest-rate events. In this U.K. debate, the model of the 'firm as a venture' was seen to inform notions of appropriateness different to those notions of appropriateness that were informed by a model of the 'firm as a portfolio manager'. Traditional notions of appropriateness resulted in a considerable *conceptual* resistance to the proposals to consider the effects of interest rate changes on the balance sheet and in the income statement. At the same time, the models underlying much of the arguments seemed to be self-reinforcing. They became self-referential and operationally closed to the extent that meaning referred to meaning. Interpretations of what was considered appropriate came

to rely on previous interpretations. Thus, in their use, the extant accounting categories for constructing financial risk supported notions of appropriateness of extant accounting categories, while rejecting others.

While there seemed to be high demands for consistency of the proposed guidance, this analysis of the regulatory debate suggested that justifications for the novel accounting guidance needed to be able to impact on incumbent notions of what accounting can and appropriately should represent. As of today, it remains to be seen whether the emerging notion of 'fair value' or notions of appropriateness associated with the model of the 'firm as a portfolio manager' eventually lead to sustainable shifts in accounting categories. While the traditional accounting model, appealing to prudence and conservatism, came to be reinforced by accounting practices such as provisioning and hedging, attempts to introduce new accounting guidance faced the challenge to make sense of the guidance *and* to shift incumbent notions of appropriateness. In other words, the regulatory debate came to be about the meaning of accounting as much as about accounting techniques. Subtle shifts were seen to take place in the meaning given to accounting, as even some of the more critical contributors came to share the view that accounting would eventually move closer to a current-value or fair value measurement system for *all* financial instruments.

Working out solutions

With becoming framed as accounting objects, financial instruments became amenable to regulatory initiatives. However, despite the framing of financial instruments in terms of conceptual framework notions of assets and liabilities, the project faced considerable difficulties in capturing financial instruments within established categories for recognition and measurement. Over time and again, the regulatory debate associated with the international financial instruments project grappled with recognition and measurement guidance involving the appropriate assessment of financial risks that financial instruments were seen to entail.

The IASC Exposure Draft E40 came to confirm both the scope decisions and the 'solution' of recognition and derecognition guidance, which were proposed in the DSOP. The close

network of experts, ideas and organizations associated with the Steering Group supported notions of appropriateness to frame transfers in terms of the *risks and rewards* they entailed. While seemingly aligned with framework notion of assets and liabilities, this guidance still relied on management's subjective association of specific instruments with outcomes of future events. However, as the subsequent rejection of both E40 and E48 illustrated, this reliance on management's assessment, which had emerged in the Steering Committee in reference to previous international practice, failed to find sufficient allies among other experts and standard setters. The profession and national standard setters faced strong demands within their jurisdictions to reduce the scope for management discretion even further.

As discussed in chapter four, earlier attempts to reflecting financial risks in financial reporting tended to be less systematic and only gradually became the subject of accounting regulation. The traditional recognition and measurement of provisions for contingencies had become discredited as too discretionary. Over time, and more so since the foundation of more independent standard setting bodies, regulatory notions of appropriateness of accounting solutions had come to support limiting the scope for management discretion, even more so as accounting faced blame for instances of creative accounting. In the IASC's project, an appropriate solution thus seemed to emerge with the *separation* of recognition from notions of reliable measurement. Recognition eventually came to be associated with contracts that established a financial instrument. For recognition guidance, this allowed disregarding the reliable measurability of contingent rewards and risks and thus limiting scope for discretion. At the same time, this change in recognition guidance, first proposed by the Discussion Paper 1997, shifted assessment of risks and rewards to *de*recognition and *measurement* following initial recognition.

As it allowed placing financial instruments *on* the balance sheet, separating financial risk assessment from recognition guidance was seen to solve the problem of *off*-balance sheet risks. However, it increased demands for appropriate measurement after initial recognition. Potential market transactions were first considered as providing an appropriate measure for reflecting the financial risks. In the course of the IASC's financial instruments project

however, the notion of *fair value* gained in importance. The notion of fair value came to be appreciated even more as an appropriate reference value for measurement the more it became seen as a measure that objectively reflected the reality of market transactions and as being non-discretionary. By the time of the IASC's Discussion Paper 1997, fair value had come to be seen as an ideal-type market transaction based on a theoretical model of market pricing, a model value that could even be extended to hypothetical values. Eventually, even empirical market values became seen as more or less reliable approximations of the more general notion of fair value that was associated with an ideal market transaction.

The notion of fair value measurement received considerable support from ideas developed in financial economics about how markets worked. At the same time, it promised a solution to the joint problem of recognition and measurement by appropriately reflecting financial risks. Furthermore, the measurement reference to the ideal of fair value allowed extending considerably the scope for accounting representations. It allowed constructing financial risk measures in accounting terms for any financial instrument by associating future cash flows with underlying contracts. Fair value measurement thus promised a new space for the application of professional knowledge, although, initially, guidance on fair value measurement remained rather weak. Propagating the notion of fair value entailed the promise of capturing risks of financial instruments within the confines of what accounting appropriately can and should represent. The remaining, but intricate measurement issues were preempted by emphasizing the dynamics of financial markets. The regulatory debate thus came to rely on a presumption that, over time, measurement techniques would evolve allowing the fair valuation of most financial instruments, including those that were not traded in liquid markets.

Bankers resisted the enthusiasm for fair values and did not share the presumption that market-based or professional knowledge-based fair valuation techniques would emerge to appropriately construct financial risk representations in accounting terms. In particular, bankers strongly rejected moving towards fair value measurement for their traditional banking book. Fair value was not seen to correspond to the way banks had come to represent financial risks in their asset-liability management. Bankers' resistance to the fair value

approach, which increasingly came to shape the politics of the financial instruments project, related mainly to the visibility of financial risks. Bankers became particularly weary of risk representations that would expose them to professional guidance controlled by accountants, which they argued to be *unreliable*. Bankers shared notions of appropriateness suggesting that the area of credit risk assessment had to remain at the heart of their own professional jurisdiction. However, by the end of the 1990s, banking representatives had only partially steered the regulatory debate to accept guidance supported by *their* notions of appropriateness, which involved classifying instruments either as part of the trading or the banking book.

Meanwhile, in appealing to the notion of fair value, the closely-knit network of experts in the regulatory debate became aligned with categories of risk that were seen to be close to financial economics. These notions of appropriateness, which appealed to the relevance of future events for measurement, conflicted with the traditional meaning given to accounting and traditional ways to portray in financial reports the risks that firms were seeing themselves exposed to. As discussed in chapter five, conflicting notions of appropriateness of problems as well as solutions came to shape the subsequent regulatory debate. These different notions came to differ in their conceptualization of entities and financial risks, which we came to associate with underlying models of the firm. Rejecting particular meaning attributed to accounting involved instigating alternative models. Because justifications referred to meaning supported by allies within meaning-reproducing networks, shifts in meaning came to demand strong coalitions. This structural requirement for supporting coalitions may explain some of the pressures for international collaboration in the financial instruments project, which will be discussed in more detail in the next section.

Bearers of appropriateness

The previous section considered some of the more intangible aspects of the network that was seen to structure the accounting debate and to inform notions of appropriateness. While tangible and intangible aspects often seem to coincide, this section highlights some of the *tangible* aspects of the network, the involvement of experts and organizational actors, which

came to structure the international debate on financial instruments.[283] Singer (1990) emphasized the close link between tangible and intangible aspects by arguing that regulatory debates[284] come to be structured by a network of actors that cluster around *a priori* beliefs. 'Beliefs', which may be seen to serve a similar purposes to our models of the firm, were seen to inform what we have come to call here notions of appropriateness of problems and solutions. Meanwhile, Singer's model seems to imply that policy makers act as mere translators of ideas from *ex ante* beliefs. The notion of meaning-reproducing network rather implies to think about ideas and other non-individuals as independent analytical units, as analytically separable network actors. As a matter of style, this may not require to go as far as letting inanimate objects speak for themselves, as Latour (1996) suggests. However, it highlights that ideas and physical actors, which become associated only within a network, may be studied as genuine parts of this network.

By the end of 1998, after more then ten years of regulatory debate, the IASC's financial instruments project had yielded two standards. A disclosure and classification standard (IAS 32) was published in 1995 and a standard on recognition and measurement (IAS 39) came to be finalized at the end of 1998. Of possibly larger significance for the future of financial instruments accounting became the establishment in 1997 of the JWG that was launched to develop an even more comprehensive set of standards for recognition and measurement. During the ten years between 1988 and 1998, an increasingly tightly knit international network of experts and organizations came to crystallize around the IASC's financial instruments project. Members of the network not only became active contributors to this project, but they also came to pursue other national and multilateral projects on representing financial risks. Over time, the network of experts, organizations and ideas that clustered around the IASC's project thus became an increasingly focal point for international standard setting in the field of financial instruments.

As discussed in chapter three, the IASC came to strengthen its claim to deal internationally

[283] For the European players in accounting regulation see for example the collection of papers on European accounting regulation (McLeay 1999), for background on accounting regulation in the U.S. refer to [Miller, 1998 #762].
[284] Singer (1990) rather refers to the debate as a 'policy arena'.

with the issue of financial instruments by pulling in allied experts and standard setting organizations. At the same time, the project faced the need to balance the involvement of national standard setters with keeping a certain distance to them. As early as 1987 had the IASC come to involve the FASB on its Board as an observer, and in 1988 did the FASB become a member of the Financial Instruments Consultative Group. The IASC involved the Canadian standard setter at the staff level of the project. Other standard setters, like the ASB, became involved later and came to consider their own regulatory efforts as contributions to the international debate on financial instruments. The appropriate balance between involvement with national standard setters and distance to them did come to be seen as a matter of the IASC's credibility, in particular during the later period of the project. In 1997, after the IASC Steering Committee had produced its Discussion Paper, the staff of the IASC suggested adopting the proposed U.S. standard for derivatives and hedging activities (FASB 1996a) as an interim solution. However, particular European representatives on the IASC Board came to reject fiercely the idea of adopting a standard that was drafted essentially by the Americans:

> *Well I suppose it's like anything in international politics ... that it's a trade off ... if they push too far somebody might say to FASB, 'thanks, but we really can't pay that price, we'll go off and develop our own standards.' In which case they are left outside. On the other hand for IASC to go and do that is a bit counterproductive because if you ... you know, if a financial instrument standard doesn't cover the major countries for many multinational corporations it's counterproductive. So I suspect that is a situation where IASC needs FASB in, in order to have a credible international standard. An international standard without FASB wouldn't be highly ... credible. An international standards that goes too close to FASB damages IASC's credibility.* [285]

Initially, the involvement of national standard setters and other regulators like the SEC was seen to strengthen the legitimacy of the IASC's project. However, repeatedly standard setters came to oppose the IASC project. For example, the guidance proposed in E48 was seen to fail because it lacked the support of national standard setters. In 1993, partly as a response to the IASC's efforts to deal with financial instruments, four of the more important national standard setters, the ASB, the FASB, the CICA and the Australian Accounting

[285] Interview T, October 1998.

Standards Board (AASB) established a group of standard setters called the G4 (Street and Shaughnessy 1998). The collaboration of the G4 came to rest particularly on their shared notions of appropriateness concerning the role of conceptual framework: all four members had a conceptual framework in place or were working on introducing one. The conceptual framework associated with what might be called a 'balance sheet perspective' was seen to inform the G4's notions of appropriateness. These notions of appropriateness restricted the potential membership of the group:

> *All have the same objective for financial reporting ... in other words, to provide useful information to capital market participants. This is not the goal of financial reporting in, for instance, continental law countries, Germany, France, Switzerland, Japan, etc.*[286]

These notions of appropriateness came to spoil the chances of the IASC's Exposure Draft E48. During a meeting between the IASC and national standard setters in Edinburgh in June 1994, the G4 group of national accounting standard setters withdrew their support for the recognition and measurement portion of E48. They rejected to support what they conceived to be an approach that would inappropriately formalize current practice:

> *I think the recognition that the standard setters wouldn't wear that came in Edinburgh. ... I think it became quite clear that if you wanted the standard setter on board you had to ... not be jumping ahead of them, but sort of bringing them along. And, yes I think there was ... and that issue I think is still there. I mean clearly the issue there is to what extent can you have harmonization without the international standard being very close to FASB.*[287]

During the meeting in June 1994, many constituents came to approve the IASC's comprehensive attempt to address the issue of financial instruments. Meanwhile, many standard setters, in particular the G4, remained unconvinced about certain aspects of E48. For example, the FASB came to detail its opposition to E48 as follows:

> Adoption of E48 as a standard might prove an impediment to the FASB and other countries where national standard-setting bodies are also pursuing their own financial instruments projects to establish and improve national accounting requirements. If the

---

[286] Gerhard Müller, member of FASB, during a presentation at Walter A. Haas School of Business, San Francisco, 30. October 1998. This was also made plainly clear to the newly established German standard setting body in 1998, when it suggested joining the informal G4 (interview I, July 1998).
[287] Interview T, October 1998.

> FASB's financial instruments project does result in changes to current requirements, those changed requirements might be in conflict with the provisions of E48. Although it has been asserted that E48 is "better than nothing" because it would provide guidance for countries that do not have accounting standards, it is internally inconsistent and does not provide a consistent rationale for accounting requirements that allow it to be built upon. ... Accordingly, we strongly suggest that the IASC begin by issuing a comprehensive standard that focuses on the *disclosure requirements* set forth in E48 and encourage national standard setting bodies to adopt that standard.[288]

The notions of appropriateness that had emerged in the context of the FASB's internal debate and in the debate of the G4 had led to embracing more broadly the notion of fair value for measuring financial instruments. In contrast, E48 limited the requirement for fair value measurement to 'operating' instruments and what became called 'allowed alternative', while retaining hedge accounting based on management's classification of items.[289] As it depended on their international support, the IASC could hardly ignore the resistance by national standard setting bodies to its proposed accounting guidance. Subsequently, in 1995, the IASC issued IAS 32. As implied by the FASB and likeminded commentators, this standard was only to contain the disclosure section of E48 as well as the balance sheet classification between equity and liability.

One repercussion of the Edinburgh debacle was that the IASC sought to establish closer links with the G4 standard setters. A subsequent series of working papers came to be published jointly under the acronym G4+1, indicating the IASC's involvement. Two of these papers became particularly relevant for the financial instruments project. One paper discussed the relevance of 'future events' for recognition and measurement (Johnson 1994) and was being prepared at the time of the Edinburgh meeting. The other addressed 'major issues related to hedge accounting' (Adams and Montesi 1995). Both of these publications became important actors in the network that came to structure the debate on financial instruments after 1994. As discussed in more detail in chapter four, both papers contributed to shifting the notions of appropriateness with respect to the accounting presentation of financial risks and the ideal of market based measurement.

---

[288] Letter by James Leisenring, member of the FASB, to the IASC, 26 July 1994, original highlights.
[289] Refer to appendix A4. Compared to E40, hedge accounting was even broadened in E48.

The Edinburgh event also led to the restructuring of the IASC's Steering Committee. Alex Milburn, a proponent of conceptual frameworks and capital markets theory (Milburn 1988b; Milburn 1991), came to chair the new Steering Committee. As it embraced and conceptually justified the notion of fair value in its Discussion Paper 1997, the IASC's Steering Committee subsequently came to receive praise from some important constituents, including the G4. The Discussion Paper soon became an important element in the international regulatory debate.[290] However, contrary to the suggestions advanced in the paper, the IASC proceeded its project with what became referred to as an 'interim' accounting solution, which only selectively relied on fair values. However, it made closer references to classifications that had emerged in the context of the FASB's project and it got the FASB more closely involved in drafting the standard:

> *So what they seemed to have done is a fairly neat solution: get an American member of staff to rush to write a standard... I suspect that financial instruments, more than most other documents, has been ... people have known that there is political issues at play, as well as technical issues.*[291]

Paul Pacter, an academic and long-serving technical expert of the FASB, single-handedly wrote the 'interim' solution that came to be published as IAS 39 in March 1999. However, he drafted it in very close consultations with technical staff of the FASB drawing on some of the same technical advisors that FASB was working with.[292] Although not a plain copy of SFAS 133, the draft statement came to adopt the U.S. categories with regards to the classification of financial instruments and the guidance on hedge accounting.[293]

Largely as a result of an initiative by the G4, the IASC eventually came to sponsor the international JWG that was to be chaired by Alex Milburn and that was to foster a solution based on those notions of appropriateness that were implied in the IASC's Discussion Paper 1997. The JWG not only came to involve G4 standard setters, which had by then developed

---

[290] As discussed in chapter five, while the IASC Board never endorsed the Discussion Paper by the Steering Group, the paper came to shape the notions of appropriateness underlying the work of the JWG.

[291] Interview T, October 1998.

[292] Two important advisors were John Smith of Deloitte & Touche and John Stewart of Arthur Andersen. Interview I, July 1998.

[293] Refer to appendix A4 for more details on measurement and hedging guidance in IAS 39.

a strong working relationship, but it also came to engage representatives from other major jurisdictions with developed capital markets. Thus, while the JWG became a forum for debating new guidance on financial instruments, it may also be considered to have served as a model for the emerging new structure of the IASC.

As the early project of the IASC and the creation of the JWG illustrate, the international regulatory debate on accounting for financial instruments became gradually structured by a closely-knit network of experts and organizations with increasingly *formal* links. Even at the time when the IASC and the Canadian institute came to embark on their joint venture in 1988, the debate on financial instruments had been structured by an increasing global network, which came to cut across national boundaries, but relied more on informal ties. Since the IASC came to pursue its project on financial instruments, it had relied on this closely-knit network of experts, which increasingly came to play related roles with regards to financial instruments in other jurisdictions.

With establishing the JWG, the formerly informal links gained visibility. With its formalization, the network supporting and structuring the financial instruments debate was extended, strengthening actors that were only marginally involved before. Increasingly the international project itself became the focal point for standard setting on financial instruments. At the same time, this network strengthened notions of appropriateness that came to be informed by the conceptual framework and an increasing commitment to fair value measurement for financial instruments.

The international financial instruments project thus casts into the open the increasingly global structure of international regulatory debates. In previous standard setting projects, national standard setters had often collaborated informally and accounting concepts were repeatedly seen to travel indirectly between jurisdictions. In the case of financial instruments, the international collaboration came to thrive partly because of the technical and conceptual intricacies involved. The G4 group of standard setters that came into existence during the early 1990s made this international collaboration more visible. Eventually, with the JWG a close group with representatives from major standard setters

came to develop proposed guidance aiming for global applicability. At the same time, while the previous informal collaboration seemed to be bonded by conceptual commitments, a major challenge of the JWG became that members from 'non-framework' jurisdictions were seen to weaken the conceptual consistency of the group.[294]

In itself the issue of financial instruments may have played the role of an important catalyst for the increasing globalization of accounting standard setting. It not only brought experts to work together, it also pulled together contributors in the wider public domain, most of them representatives from international banks and multinational firms. The degree of overlap between national debates and the international debate was particularly strong in the case of the U.K. In particular those U.K. constituents that were very active contributors at the national level were also seen to contribute to the international debate on financial instruments.[295]

The closely-knit network that structured the debate on financial instruments seems to have been fostered by two related forces.[296] On the one hand, there was the highly technical nature of financial instruments. On the other hand, there was a strong involvement of the large accounting firms, either directly or through the professional institutes along with the G4 standard setters. The strong involvement of large accounting firms in the financial instruments project was also reflected by the involvement of large accounting firms in the Joint Working Group.[297] While this casts some doubts on the degree of independence from the profession, the debate was seen to gain independence in a conceptual sense, an aspect, which is discussed further below. Meanwhile, beyond the success or failure of the financial instruments project, it will be interesting to watch the JWG in the near future as a test case for the emerging global standard setting regime.

---

[294] Interview b, December 1998.
[295] Refer to appendix A5, table A5.4 and the respective comments.
[296] Refer to table A5.1 for an overview of contributors by national origin.
[297] Refer to tables A5.2 and A5.3 and corresponding comments.

Further implications

A number of further implications can be seen to arise from our discussion of the international financial instruments project. These implications entail both a policy and a theoretical dimension and suggest some refinement to our model of the network that was seen to structure the regulatory debate. These implications concern the conceptual power of frameworks, notions of conceptual independence and the future demand for accounting regulation. They will be discussed in turn in this concluding section of the thesis.

Conceptual power of frameworks

In this thesis we came to characterize accounting regulation as an intellectual endeavor. The way the regulatory debate appealed to conceptual ideas suggests that it shared many characteristics with an academic discourse. To the degree it involved conceptual justifications, the debate seemed to involve the production and reproduction of meaning given to accounting representations. For example, in chapter five, the regulatory debate on financial instruments was described as a debate about different meanings given to accounting, while fundamental positions in the debate were traced to differences in underlying models about how to conceptualize reporting entities. Watts and Zimmerman (1979) had come to characterize the intellectual endeavor involved in accounting regulation as a market for excuses, which may be provided on demand. In contrast to the metaphor of the market, the case presented here highlights the difficulties and resources involved in invoking theories to furnish excuses, whether they are opportunistic or not. To be meaningful, contributions were seen to be in need of conceptual support from what we have synthesized as underlying models. As notions of appropriateness of accounting problems and solution came to draw on support from such underlying models, the possibilities of accounting these models were able to frame came to structure the regulatory debate.

Like other forms of meaning, the meaning attributed to accounting was seen to find confirmation in its use. As we saw with respect to the model of the 'firm as a venture', the model reinforced notions of appropriateness that attributed significance to future events according to the way accounting was currently employed. While it rendered meaning to

current practice, the model itself was confirmed by this current practice. In debating the meaning of accounting, reference to the significance of specific events as 'real' was seen to hide the circularity in this reproduction of meaning. The degree to which repercussions of future events could be signified as 'real' thus became the subject of the regulatory debate. Recasting the significance of future events was involved in problematizing recognition and measurement for financial instruments as well as in the rise of fair value. While it was not congruent with traditional meaning, the notion of fair value was seen to receive support to the degree that representing effects of future events came to be appealing as a regulatory *telos*. And it became even more attractive as it was seen to extend the possibilities of accounting in representing financial risks.

Accounting notions that were informed by the conceptual framework came to support the reproduction of meaning 'in use'[298] in the regulatory debate. As discussed in chapter three, the IASC's project came to emerge in reference to the notion of 'financial instruments', conceptualized as a financial asset, a financial liability, or an equity instrument. Classifying financial instruments in terms of conceptual framework elements such as assets and liabilities afforded important conceptual building blocks to frame the diverse phenomena of 'off-balance sheet financial risks' in accounting terms. In this way did the conceptual framework come to supply selective support for notions of appropriateness. The conceptual framework acted as a resource on which the regulatory debate was drawing selectively for confirmation. In a similar sense, Macve (1981) suggested that the conceptual framework might render support for considering issues in 'a sensible pattern'. Meanwhile, in the case of financial instruments, this support for making sense was seen to derive less from the supply of first principles. Rather than providing a deductive foundation to 'solve' the representation of off-balance sheet risk, the conceptual framework helped to make sense through *selective* reference to some of its elements.

Understanding the conceptual framework as a credentializing resource is far from the normative ideal associated with the conceptual framework in the model of the ideal

[298] 'Meaning in use' may be thought of similarly to theories-in-use, see Argyris (1992).

profession. In a sense, this understanding is closer to Watts and Zimmerman's (1979) notion of theories as goods supplied on demand. On the other hand, the debate on financial instruments itself demanded high conceptual consistency in order to make sense internally. The demands for consistency of the debate seemed to be stronger than demands for congruence with the conceptual framework. For example, as discussed in chapter four, the recognition guidance that was proposed in the IASC's Discussion Paper 1997 came to conflict with the IASC conceptual framework. Rather than adopting the framework notions of recognition, the framework became reinterpreted as to fit the meaning of the proposed guidance.

While it was seen to be a necessary element in credibly establishing the scope and the foundation of the project, the conceptual framework may be seen as just one element, one actor in the network that supported notions of appropriateness of the emerging problems and solutions. Likewise, as future accounting issues may become as conceptually demanding as financial instruments, the role of the framework as a resource for advancing alternative interpretations of events, as an 'interrupt stack' for meaning reproduction, may become ever more important. However, this role is likely to remain merely supportive to the notions of appropriateness and the meaning that emerge in the regulatory debate. Unlike other expectations held in this respect, in the case of financial instruments the conceptual framework was seen to strengthen independence from third party intervention only to the degree that it was seen to satisfy and support the consistency of the notions of appropriateness reproduced in the debate.[299]

Notions of independence

In the case of financial instruments, the regulatory debate crystallized notions of appropriateness, which seemed to act as a defense against crude interference thus strengthening the conceptual independence of the standard setting process. In this respect, framework supported notions such as 'financial assets' and 'financial liabilities' were seen

[299] Regarding the suggested role of the conceptual framework with respect to third party intervention, see for example Macve (1981) and Tweedie (1996).

to act as intellectual signposts delineating the emerging possibilities of accounting. The emerging notion of *fair value* even supported a program, which strengthened the 'systemic' logic of accounting regulation beyond immediate practical concerns. While the case does not suggest that the process of accounting regulation was non-responsive to external pressures - after all the projects emerged subsequently to the rise of wider regulatory concerns -, the effects of external pressures were surprisingly different from what capturing theory would suggest. Specific demands from lobbying constituents, such as banks, were seen to strengthen conceptual commitments in the regulatory debate rather than weakening them. Such conceptual commitments towards the ideal to represent the 'reality' of market transactions were likely to transcend most of the particular concerns about specific aspect of accounting representation.

Rather, the commitments to an ideal representation, for example, fair value, and the associated notions of appropriateness strengthened the conceptual independence of the regulatory debate. Conceptual sophistication thus came to immunize the regulatory debate to disturbances resulting from simplistic demands. Contributions were mediated by the network of experts, organizations and ideas that structured the debate by rendering them either meaningful or not. With respect to the later case, contributions could be seen as being ignored.[300] While the regulatory debate was seen to respond to external pressures, it seemed to operate with notions of appropriateness stabilized by a selected stream of contributions, which were occasionally gaining some distance from notions of appropriateness still prevailing in accounting practice. The regulatory debate thus reproduced its mission in terms of the meaning it gave to accounting, for example in representing financial risks associated with future events. For describing this regulatory logic, we may refer to Luhmann (1995), who argued that meaning is not established in reference to an external referent but in reference to a path of previous understandings.[301]

---

[300] In particular, many banking representatives shared the impression that their contributions to fend of disclosures and a more comprehensive fair value model had been ignored (Interview U, October 1998).

[301] Some authors have attempted to apply Luhmann's notion of social systems to accounting issues (Robb 1991; Baecker 1992). Others have come to reflect more generally on aspects of Luhmann's social systems theory in the context of accounting regulation and auditing (Miller and Power 1992; Power 1994).

The primary concern of a meaning reproducing system may be seen less related to the transformation of inputs into output in response to a particular purpose and more related to safeguarding the reproduction of meaning and internal notions of appropriateness. In this sense, mechanisms of operational closure and self-reproduction can be seen to work in social systems as much as in biological systems. However, operational closure and reproduction of meaning and notions of appropriateness do not need to exclude interactions with the environment, with which the system remains structurally coupled, nor do they exclude learning. While meaning and notions of appropriateness may be thought off as changing primarily in relation to internal dynamics, these changes may be seen to be in relation to environmental changes as well, but less directional than is often assumed. We should bear in mind that any systematic association between changes in the environment and structural changes in the regulatory debate tend to be our constructs as observers who simultaneously observes both, changes in the environment and in the debate. As suggested by the case of financial instruments, the debate reflected the environmental changes and the considerable crisis of legitimacy of accounting. However, the adaptation to this changing environment was less a matter of a linear process, but rather the result of many tentative and undirected shifts of meaning and of notions of appropriateness along with but not necessarily determined by changes in the environment.

Elsewhere (Giddens 1984), micro-produced macro order has been characterized as structuring institutions that do not exist independently to guide action, but exist through 'instantiations' in practices. Giddens referred to this as the duality of structure. The duality principle implies that the reproduction of structure, the rules and resources drawn upon in social action, occur through social action itself and the intended and unintended consequences of such action, referred to as feedback loops. With all social interaction expressed at some point in and through the bodily agent, Giddens argues that the analysis of institution building should involve to 'thread outwards' from the context of practices into wider reaches of time and space. In particular routinization should be analyzed as a temporal thread away from the immediate contexts of action and interaction.

In the context of our inquiry, we came to focus on a regulatory debate and contributions to

this debate rather than limiting the analysis to the bodily agents involved in accounting regulation. We considered what Giddens calls structure as comprising of meaning and notions of appropriateness supported by a network of experts and organizations but also ideas and concepts. Rather than threading outwards in time and space, our analysis attempted to thread outwards in time and with respect to the various actors of the network that rendered certain contributions appropriate and others not. The boundaries of the debate were thus not physical. Even physically remote contributions from and within different organizations, professional institutes, and between accounting standard setters, general ideas and experiences were seen to contribute to the debate and to its selectivity in supporting notions of appropriateness.

Rather than simply following it, the international regulatory debate on financial instruments as it is characterized here constructed the functional *telos* of accounting. In constructing its functional *telos*, the debate was also seen as safeguarding professional and institutional claims for jurisdiction. As notions of appropriateness and meaning became challenged they were hardly ever stable and demanded ongoing reproduction. Giddens was careful enough to note that interpretative schemes are 'standardized stocks of knowledge, applied by actors in the production of interaction', rather than coherent, uniform shared and stable sets of meanings (Giddens 1979; Boland 1996). In the terms suggested here this means that the selectivity in the regulatory debate resulting from notions of appropriateness and meaning became enacted in the course of the debate. As we discussed in chapter five, variations to meaning - and thus shifting notions of what accounting can or should represent - seemed to be slow and unpredictable. Changes in meaning were not established by isolated floating ideas but by assemblies of mutually reinforcing notions of appropriateness. As in science (Latour 1987), emerging notions in accounting regulation needed allies to establish a difference in the meaning given to accounting. It is for this structure that the regulatory debate may not to be controlled by individual contributors, because contributors themselves are subject to the selectivity prevailing in the debate. And it is for this selectivity that we may speak about conceptual independence of the regulatory debate.

Continuous endeavor

After publishing an accounting standard for financial instruments (IAS 39) and after embarking on a comprehensive project in the context of the JWG, will there ever going to be a final set of accounting standards for financial instruments? The modernist model of the ideal profession, discussed in chapter two, relied on an ideal set of standards as the *telos* of standard setting. Correspondingly, much of the IASC's effort in developing a core set of standards was undertaken under the assumption that there would be an end to it.[302] The model of political lobbying and the model of the professional jurisdiction rather implied that standards, as they are considered as means rather than ends, might change as long as the social environment changes. This is more in line to what our case of financial instruments suggests. While the negotiation of accounting standards takes considerable time, the target seems to be moving as well. This happened throughout the IASC's project and can be observed particularly well in the current re-negotiation of the related U.S. standards SFAS 125 and SFAS 133.

A theoretical explanation may be that in a regulatory debate with shifting and contested notions of appropriateness there is considerable demand for the reproduction of meaning. As we have argued, the meaning given to accounting representations is intangible, temporal and only enacted in regulatory debates that are structured by meaning-reproducing networks. In the process of its discursive reproduction, the meaning given to particular accounting representations may remain ambiguous. Furthermore, with the reproduction of meaning, variations may possibly occur and the meaning may thus become subject to unexpected change. While variations to meaning and shifts in the notions of appropriateness supported by the meaning-reproducing network tend to be slow, as they are not established by isolated floating ideas but by a network of mutually reinforcing claims, they are unpredictable an possibly never ending.

An important aspect of notions of appropriateness and meaning given to accounting

[302] For instance, it was agreed with IOSCO that a core set of standards would initially be sanctioned, but not how future changes to these core standards would be authorized (interview J, July 1998).

representations thus seems to be their instability. Regulatory debates in accounting seem to thrive on this instability. For instance, following IAS 32, the ambiguity involved in classifying liabilities and equity in new ways, fostered a debate in the IASC's Standing Interpretations Committee. Even after issuing an interpretation (for example, SIC-17), there remained a degree of vagueness inducing further intellectual reassurances by various experts about the substance of an innovative transaction. An ongoing discourse thus crystallized around the ambiguity involved in distinguishing between debt and equity. Rather than settling the issue once and for all, any further codification, for example in the form of an interpretation of a standard, seemed to create further demand for interpretations.

Regulatory debates that are structured by meaning-reproducing networks thus seem to make new contributions more likely by provoking challenges to prevailing meaning. Thus, while, as we argued above, the structure of the regulatory debate may be considerably resistant to radical changes, it still remains subject to what we may call evolutionary variations. Within the regulatory debate on financial instruments, notions of appropriateness did not seem to change *ad hoc*, only through gradual shifts in the supporting network and the meaning given to particular accounting representations. The regulatory debate may thus be seen to operate under conditions of a 'dynamic stability'. While changes are gradual and emerge as variations to existing notions of appropriateness, there is likely to be no end to the regulatory debate as long as firms are being made visible by ambiguous accounting categories and as long as claims to financial representation of accounting entities require justification.

References

Abbott, Andrew (1988), The System of Professions: An Essay on the Division of Expert Labor, The University of Chicago Press: Chicago and London.

Abraham, S. C. (1978), The Public Accounting Profession, Heath: Lexington, MA.

ACT (1995), Derivatives for Directors, November 1995, Association of Corporate Treasurers: London.

Adams, Jane B. and Corliss J. Montesi (1995), Major Issues Related to Hedge Accounting, G4+1 Special Report, October 1995, Financial Accounting Standards Board: Norwalk, CT.

Adedeji, Abimbola and C. Richard Baker (1999), Financial Reporting of Derivatives Before FRS 13, in: Derivative Use, Trading and Regulation, Vol. 5, No. 1, pp. 51-62.

AICPA (1973), Objectives of Financial Statements, Accounting Objectives Study Group, American Institute of Certified Public Accountants: New York.

AICPA (1985), Accounting for Options, Issues Paper prepared by Task Force on Options, Accounting Standards Division, American Institute of Certified Public Accountants: New York.

Amershi, Amin H., Joel S. Demski, and Mark A. Wolfson (1982), Strategic Behavior and Regulation Research in Accounting, in: Journal of Accounting and Public Policy, Vol. 1, pp. 19-32.

Anonymous (1983), The FASB's Second Decade: A Focus on 12 Issues, in: Journal of Accountancy, Vol. 156, No. 6, December 1983, pp. 94-102.

Anstis, Clark M. (1994), Illustrations of Financial Instrument Disclosures, Special Report, December 1994, Financial Accounting Standards Board: Norwalk, CT.

Archer, Simon (1993), On the Methodology of Constructing a Conceptual Framework for Financial Accounting, in: Michael J. Mumford and Ken V. Peasnell (eds.), Philosophical Perspectives on Accounting: Essays in Honour of Edward Stamp, pp. 62-122, Routledge: London.

Archer, Simon (1997), The ASB's Exposure Draft Statement of Principles: A Comment, in: Accounting and Business Research, Vol. 27, pp. 229-241.

Arden, Mary (1993), The True and Fair Requirement, in: Accounting Standards Board (ed.), Accounting Standards, pp. 22-26, ICAEW: London.

Argyris, Chris (1992), On Organizational Learning, Blackwell Publishers: Oxford.

ASB (1992), FRED 3 - Accounting for Capital Instruments, Financial Reporting Exposure Draft, December 1992, Accounting Standards Board: London.

ASB (1993a), FRED 4 - Reporting the Substance of Transactions, Financial Reporting Exposure Draft, February 1993, Accounting Standards Board: London.

ASB (1993b), FRS 4 - Capital Instruments, Financial Reporting Standard, December 1993, Accounting Standards Board: London.

ASB (1994), FRS 5 - Reporting the Substance of Transactions, Financial Reporting Standard, December 1994, Accounting Standards Board: London.

ASB (1995), Exposure Draft: Statement of Principles for Financial Reporting, November 1995, Accounting Standards Board: London.

ASB (1996), Derivatives and Other Financial Instruments, Discussion Paper, July 1996, Accounting Standards Board: London.

ASB (1997a), FRED 13 - Derivatives and Other Financial Instruments: Disclosures, Financial Reporting Exposure Draft, April 1997, Accounting Standards Board: London.

ASB (1997b), FRED 13 Supplement - Derivatives and Other Financial Instruments: Disclosures by Banks and Similar Institutions, Financial Reporting Exposure Draft, July 1997, Accounting Standards Board: London.

ASB (1998), FRS 13 - Derivatives and other Financial Instruments: Disclosures, Financial Reporting Standard, September 1998, Accounting Standards Board: London.

ASC (1977), ED 21 - Accounting for Foreign Currency Transactions, Exposure Draft, September 1977, Accounting Standards Committee: London.

ASC (1980), ED 27 - Accounting for Foreign Currency Translations, Exposure Draft, October 1980, Accounting Standards Committee: London.

ASC (1981), ED 29 - Accounting for Leases and Hire Purchase Contracts, Exposure Draft, October 1981, Accounting Standards Committee: London.

ASC (1983), SSAP 20 - Foreign Currency Translations, Statement of Standard Accounting Practice, April 1983, Accounting Standards Committee: London.

ASC (1984), SSAP 21 - Accounting for Leases and Hire Purchase Contracts, Statement of Standard Accounting Practice, August 1984, Accounting Standards Committee: London.

ASC (1988), ED 42 - Accounting for Special Purpose Transactions, Exposure Draft, March 1988, Accounting Standards Committee: London.

Atkinson, Michael M. and William D. Coleman (1992), Policy Networks, Policy Communities and the Problems of Governance, in: Governance: An International Journal of Policy and Administration, Vol. 5, No. 2, pp. 154-180.

Axelrod, Robert (ed.) (1976), Structure of Decision: The Cognitive Maps of Political Elites, Princeton University Press: Princeton, NJ.

Baecker, Dirk (1992), The Writing of Accounting, in: Stanford Literature Review, Vol. 9, No. 2, pp. 157-178.

Barth, Mary E., Wayne R. Landsman, and Jr. Richard J. Rendleman (1998), Option Pricing-Based Bond Value Estimates and a Fundamental Components Approach to Account for Corporate Debt, in: Accounting Review, Vol. 73, No. 1, pp. 73-102.

BBA (1991), SORP: Off-Balance-Sheet Instruments and Other Commitments and Contingent Liabilities, Statement of Recommended Accounting Practice, November 1991, British Bankers' Association: London.

Bealing, William E. Jr., Mark W. Dirsmith, and Timothy Fogarty (1996), Early Regulatory Actions by the SEC: An Institutional Theory Perspective on the Dramaturgy of Political Exchanges, in: Accounting, Organizations and Society, Vol. 21, No. 4, pp. 317-338.

Beaver, William H. (1989), Financial Reporting: An Accounting Revolution, Prentice Hall: Englewood Cliffs, New Jersey.

Beder, T. Styblo (1997), What We've Learned About Derivatives Risk in the 1990s, in: Economic Notes by Banca Monte dei Paschi di Siena SpA, Vol. 26, No. 2, pp. 337-356.

Belk, Penny A. and Martin Glaum (1990), The Management of Foreign Exchange Risk in UK Multinationals: An Empirical Investigation, in: Accounting and Business Research, Vol. 21, No. 81, pp. 3-13.

Benston, George J. (1982), An Analysis of the Role of Accounting Standards for Enhancing Corporate Governance and Social Responsibility, in: Journal of Accounting and Public Policy, Vol. 1, pp. 5-17.

Benston, George J. (1986), Market-Value Reporting, in: George J. Benston et al. (ed.), Safe and Sound Banking: Past, Present, and Future, pp. 203-225, MIT Press: London.

Benston, George J. and George G. Kaufman (1997), Commercial Banking and Securities Activities, in: Clifford E. Kirsch (ed.), The Financial Services Revolution: Understanding the Changing Role of Banks, Mutual Funds, and Insurance Companies, pp. 3-28, Irwin Professional Publishers: Chicago.

Beresford, Dennis R. (1990), Internationalization of Accounting Standards, in: Accounting Horizons, Vol. 4, No. 1, March 1990, pp. 99-107.

Beresford, Dennis R. (1997), Commentary: How to Succeed as a Standard Setter by Trying Really Hard, in: Accounting Horizons, Vol. 11, No. 3, September 1997, pp. 79-90.

Bernstein, Marver (1955), Regulating Business by Independent Commission, Princeton University Press: Princeton.

Bessis, Joël (1998), Risk Management in Banking, John Wiley & Sons: Chicester.

Bierman, Harold Jr, L. Todd Johnson, and D. Scott Peterson (1991), Hedge Accounting: An Exploratory Study of the Underlying Issues, FASB Research Report, Financial Accounting Standards Board: Norwalk, CT.

Bird, Peter (1984), The Development of Standard Accounting Practice, in: Bryan V. Carsberg and Anthony Hope (eds.), Current Issues in Accounting, 2nd Edition, pp. 39-52, Philip Allan: Oxford.

BIS (1986), The Management of Banks' Off-Balance-Sheet Exposures: A Supervisory Perspective, March 1996, Basle Committee on Banking Supervision: Basle.

BIS (1988), International Convergence of Capital Measurement and Capital Standards, July 1988, Basle Committee on Banking Supervision: Basle.

BIS (1996), Overview of the Amendment to the Capital Accord to Incorporate Market Risks, January 1996, Basle Committee on Banking Supervision: Basle.

Black, Fischer (1975), Fact and Fantasy In the Use of Options, in: Financial Analysts Journal, Vol. 31, July-August, pp. 9-26.

Black, Fischer and Myron Scholes (1973), The Pricing of Options and Corporate Liabilities, in: Journal of Political Economy, Vol. 81, No. 3, pp. 637-654.

Bloomer, Carrie (ed.) (1996), The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP, 1st Edition, Financial Accounting Standards Board: Norwalk, CT.

Bloomer, Carrie (ed.) (1999), The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP, 2nd Edition, Financial Accounting Standards Board: Norwalk, CT.

Bocqueraz, Claude and Peter Walton (1999), Creating a supranational regulator: the role of the individual and the mood of the times - A case study of change in accounting, Paper presented at EIASM Workshop on Accounting in Europe VI, June 1999, in London, University of Geneva: Geneva.

Bohan, Michael (1981), Balance Sheet Financing - On and Off, in: Journal of Accounting, Auditing and Finance, Vol. 4, No. 4, Summer 1981, pp. 360-364.

Boland, Richard J. (1996), Why Shared Meanings have no Place in Structuration Theory: A Reply to Scapens and Macintosh, in: Accounting, Organizations and Society, Vol. 21, No. 7/8, pp. 691-697.

Bonoma, Thomas V. (1976), Conflict, Cooperation and Trust in Three Power Systems, in: Behavioral Science, Vol. 21, No. 6, pp. 499-514.

Borger, David (1999), Der Sinn des Rechnungswesens: Finanzinstrumente und die Reproduktion von Unternehmensgrenzen, in: Soziale Systeme, Vol. 5, No. 1, pp. 84-105.

Bourdieu, Pierre (1992a), Language and Symbolic Power, translated by: Gino Raymond and Matthew Adamson, Polity Press: Cambridge.

Bourdieu, Pierre (1992b), The Logic of Practice, translated by: Richard Nice, Polity Press: Cambridge, UK.

Bromwich, Michael and Anthony Hopwood (1983), Some Issues in Accounting Standard Setting: An Introductory Essay, in: Michael Bromwich and Anthony Hopwood (eds.), Accounting Standards Setting: An International Perspective, pp. v-xxiv, Pitman: London.

Brown, Paul R. (1981), A Descriptive Analysis of Select Input Bases of the Financial Accounting Standards Board, in: Journal of Accounting Research, Vol. 19, No. 1, pp. 232-246.

Brown, Paul R. (1982), FASB Responsiveness to Corporate Input, in: Journal of Accounting, Auditing and Finance, Vol. 5, No. 4, pp. 282-290.

Bullen, Halsey G., Robert C. Wilkins, and Clifford C. Woods (1989), The Fundamental Financial Instruments Approach: Identifying the Building Blocks, in: Journal of Accountancy, November 1989, pp. 71-78.

Burchell, Stuart, Colin Clubb, and Anthony Hopwood (1985), Accounting in its Social Context: Towards a History of Value-Added in the United Kingdom, in: Accounting, Organizations and Society, Vol. 10, No. 4, pp. 381-413.

Burton, John C. (1993), Accounting and the Regulation of Financial Institutions, in: Economic Notes by Monte dei Paschi di Siena, Vol. 22, No. 2, pp. 312-317.

Cairns, David (1997), The Future Shape of Harmonization: A Reply, in: European Accounting Review, Vol. 6, No. 2, pp. 305-348.

Cairns, David (1999), Applying International Accounting Standards, 2nd Edition, Butterworths: London.

Callon, Michel (1980), Struggles and Negotiations to Define what is Problematic and what is Not: the Sociologic of Translation, in: K. D. Knorr, R. Krohn, and R. Whitley (eds.), The Social Process of Scientific Investigation, pp. 197-220, Reidel: Dordrecht.

Callon, Michel (1998), An Essay on Framing and Overflowing: Economic Externalities Revisited by Sociology, in: Michel Callon (ed.), The Laws of the Market, Blackwell Publishers: Oxford.

Carchrae, John (1991), Financial Instruments, in: IASC Insight, July 1991, pp. 1-2.

Carmichael, Douglas and James Craig (1992), International Accounting Standards: Are They Coming to America?, in: CPA Journal, Vol. 62, No. 10, Oct 1992, pp. 16-24.

Carsberg, Bryan V., Anthony Hope, and R. W. Scapens (1973), Objectives of Published Accounting Reports, in: Accounting and Business Research, Vol. 4, No. 15, pp. 162-173.

Casson, Peter (1998), A Re-Examination of the Case for Accounting Separately for the Debt and Equity Features of Convertible Debt, in: Journal of Business Finance and Accounting, Vol. 25, No. 5/6, pp. 595-612.

CCAB (1988), The Making of Accounting Standards, Report of the Review Committee under the chairmanship of Sir Ronald Dearing, September 1988, Consultative Committee of Accountancy Bodies: London.

Chambers, Raymond J. (1955), Blueprint for a Theory of Accounting, in: Accounting Research, No. January, pp. 17-25.

Chambers, Raymond J. (1966), Accounting, Evaluation and Economic Behavior, Prentice-Hall: Englewood Cliffs.

Cheit, Ross E (1990), Setting Safety Standards: Regulation in the Public and Private Sectors, University of California Press: Oxford.

Coase, Ronald H. (1988), The Nature of the Firm, in: Ronald H. Coase (ed.), The Firm, the Market and the Law, pp. 33-55, originally published in 1937, University of Chicago Press: Chicago.

Coleman, James Samuel (1990), Foundations of Social Theory, Harvard University Press: Cambridge, Massachusetts.

Craig, James L., Jr. (1996), The Future of Private Sector Standard Setting, in: CPA Journal, Vol. 66, No. 12, pp. 26-33.

Cranston, Ross (1997), Principles of Banking Law, Clarendon Press: Oxford.

Davies, Mike, Ron Paterson, and Allister Wilson (1997), UK GAAP: Generally Accepted Accounting Practice in the United Kingdom, 5th Edition, Ernst & Young: London.

Davis, Henry (1998), Delayed But Not Dead, in: Risk, January 1998, pp. 28-31.

Deakin, Edward B. (1989), Rational Economic Behavior and Lobbying on Accounting Issues: Evidence from the Oil and Gas Industry, in: The Accounting Review, Vol. 64, No. 1, pp. 137-151.

Dieter, Richard and Arthur R. Wyatt (1980), Get It off the Balance Sheet, in: Financial Executive, Vol. 48, No. 1, January 1980, pp. 42-48.

DiMaggio, Paul J. and Walter W. Powell (1991a), Introduction, in: Walter W. Powell and Paul J. DiMaggio (eds.), The New Institutionalism in Organizational Analysis, pp. 1-38, The University of Chicago Press: Chicago and London.

DiMaggio, Paul J. and Walter W. Powell (1991b), The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields, in: Walter W. Powell and Paul J. DiMaggio (eds.), The New Institutionalism in Organizational Analysis, pp. 63-82, The University of Chicago Press: Chicago and London.

Douglas, Mary (1986), How Institutions Think, Syracuse University Press: New York.

Downs, Anthony (1957), An Economic Theory of Democracy, Harper & Row: New York.

E&Y (1996), The ASB's Framework - Time to Decide, Ernst & Young: London.

EC (1978), Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, (78/660/EEC), Council of the European Communities: Brussels.

EC (1983), Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, (83/349/EEC), Council of the European Communities: Brussels.

EC (1986), Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, (86/635/EEC), Council of the European Communities: Brussels.

EC (1991), Council Directive of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings, (91/674/EEC), Council of the European Communities: Brussels.

EC (1995), Accounting Harmonisation: A New Strategy vis-a-vis International Harmonisation, Commission Communication, November 1995, European Commission: Brussels.

EC (1998), Interpretative Communication Concerning Certain Articles of the Fourth and Seventh Council Directives on Accounting, XV/7009/97, European Commission: Brussels.

Edwards, Edgar O. and Philip W. Bell (1961), The Theory and Measurement of Business Income, University of California Press: London.

Ellinger, E.P. and Eva Lomnicka (1994), Modern Banking Law, 2nd Edition, Oxford University Press: Oxford.

Emirbayer, Mustafa and J. Goodwin (1994), Network Analysis, Culture and the Problem of Agency, in: American Journal of Sociology, Vol. 99, pp. 1411-1454.

Emirbayer, Mustafa and Ann Mische (1998), What is Agency?, in: American Journal of Sociology, Vol. 103, No. 4, pp. 962-1023.

Evans, Thomas G. and Timothy S. Doupnik (1986a), Determining the Functional Currency under Statement 52, Research Report, April 1986, Financial Accounting Standards Board: Stamford, CT.

Evans, Thomas G. and Timothy S. Doupnik (1986b), Foreign Exchange Risk Management under Statement 52, Research Report, November 1986, Financial Accounting Standards Board: Stamford, CT.

Evans, Thomas G., William R. Jr. Folks, and Michael Jilling (1978), The Impact of Financial Accounting Standards No. 8 on the Foreign Exchange Risk Management Practices of American Multinationals, Research Report, November 1978, Financial Accounting Standards Board: Stamford, CT.

FASB (1975a), SFAS 5: Accounting for Contingencies, Statement of Financial Accounting Standards, March 1975, Financial Accounting Standards Board: Stamford, CT.

FASB (1975b), SFAS 8: Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements, Statement of Financial Accounting Standards, October 1975, Financial Accounting Standards Board: Stamford, CT.

FASB (1975c), SFAS 12: Accounting for Marketable Securities, Statement of Financial Accounting Standards, December 1975, Financial Accounting Standards Board: Stamford, CT.

FASB (1976), SFAS 13: Accounting for Leases, Statement of Financial Accounting Standards, November 1976, Financial Accounting Standards Board: Stamford, CT.

FASB (1977), SFAS 20: Accounting for Forward Exchange Contracts, Statement of Financial Accounting Standards, December 1977, Financial Accounting Standards Board: Stamford, CT.

FASB (1981), SFAS 52: Foreign Currency Translations, Statement of Financial Accounting Standards, December 1981, Financial Accounting Standards Board: Stamford, CT.

FASB (1982), SFAS 67: Accounting for Costs and Initial Rental Operations of Real Estate Projects, Statement of Financial Accounting Standards, October 1982, Financial Accounting Standards Board: Stamford, CT.

FASB (1983a), SFAS 76: Extinguishment of Debt, Statement of Financial Accounting Standards, November 1983, Financial Accounting Standards Board: Stamford, CT.

FASB (1983b), SFAS 77: Reporting by Transferors for Transfers of Receivables with Recourse, Statement of Financial Accounting Standards, December 1983, Financial Accounting Standards Board: Stamford, CT.

FASB (1984), SFAS 80: Accounting for Futures Contracts, Statement of Financial Accounting Standards, August 1984, Financial Accounting Standards Board: Stamford, CT.

FASB (1985a), CON 6: Elements of Financial Statements, Statement of Financial Accounting Concepts, December 1985, Financial Accounting Standards Board: Stamford, CT.

FASB (1985b), TB 85-2: Accounting for Collateralized Mortgage Obligations, Technical Bulletin, March 1985, Financial Accounting Standards Board: Stamford, CT.

FASB (1986), FASB to Address Financial Instruments and Off Balance Sheet Financing Issues, in: Status Report, Financial Accounting Standards Board, 26 June 1986, pp. 1-2.

FASB (1987), Disclosures about Financial Instruments, Proposed Statement of Financial Accounting Standards, Exposure Draft, November 1987, Financial Accounting Standards Board: Norwalk, CT.

FASB (1989), Disclosure of Information about Financial Instruments with Off-balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk, Proposed Statement of Accounting Standards, Exposure Draft (Revised), July 1989, Financial Accounting Standards Board: Norwalk, CT.

FASB (1990a), Disclosures about Market Value of Financial Instruments, Proposed Statement of Accounting Standards, Exposure Draft, December 1990, Financial Accounting Standards Board: Norwalk, CT.

FASB (1990b), Distinguishing Between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both, Discussion Memorandum, August 1990, Financial Accounting Standards Board: Norwalk, CT.

FASB (1990c), SFAS 105: Disclosure of Information about Financial Instruments with Off-balance Sheet Risk and Financial Instruments with Concentration of Credit Risk, Statement of Financial Accounting Standards, March 1990, Financial Accounting Standards Board: Norwalk, CT.

FASB (1991a), Recognition and Measurement of Financial Instruments, Discussion Memorandum, November 18, 1991, Financial Accounting Standards Board: Norwalk, CT.

FASB (1991b), SFAS 107: Disclosures about Fair Value of Financial Instruments, Statement of Financial Accounting Standards, December 1991, Financial Accounting Standards Board: Norwalk, CT.

FASB (1992), Accounting for Certain Investments in Debt and Equity Securities, Proposed Statement of Accounting Standards, Exposure Draft, September 1992, Financial Accounting Standards Board: Norwalk, CT.

FASB (1993a), A Report on Deliberations, Including Tentative Conclusions on Certain Issues, Related to Accounting for Hedging and Other Risk-Adjusting Activities, Special Report, June 1993, Financial Accounting Standards Board: Norwalk, CT.

FASB (1993b), SFAS 115: Accounting for Certain Investments in Debt and Equity Securities, Statement of Financial Accounting Standards, May 1993, Financial Accounting Standards Board: Norwalk, CT.

FASB (1994a), Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, Proposed Statement of Accounting Standards, Exposure Draft, April 1994, Financial Accounting Standards Board: Norwalk, CT.

FASB (1994b), SFAS 119: Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, Statement of Financial Accounting Standards, October 1994, Financial Accounting Standards Board: Norwalk, CT.

FASB (1995), Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, Proposed Statement of Accounting Standards, Exposure Draft, October 1995, Financial Accounting Standards Board: Norwalk, CT.

FASB (1996a), Accounting for Derivative and Similar Financial Instruments and for Hedging Activities, Proposed Statement of Accounting Standards, Exposure Draft, June 1996, Financial Accounting Standards Board: Norwalk, CT.

FASB (1996b), SFAS 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Statement of Financial Accounting Standards, June 1996, Financial Accounting Standards Board: Norwalk, CT.

FASB (1997a), Accounting for Derivative and Similar Financial Instruments and for Hedging Activities, Proposed Statement of Accounting Standards, Exposure Draft (Revised), August 1997, Financial Accounting Standards Board: Norwalk, CT.

FASB (1997b), Using Cash Flow Information in Accounting Measurement, Proposed Statement of Financial Accounting Concepts, Exposure Draft, June 1997, Financial Accounting Standards Board: Norwalk, CT.

FASB (1998a), Investment Community Interest in Reporting the Fair Values of Financial Instruments in Financial Statements: A Focus Group Summary - Final Report, Special Report Commissioned by FASB, AIMR, and CICA, June 1998, Financial Accounting Standards Board: Norwalk, CT.

FASB (1998b), SFAS 133: Accounting for Derivatives and Hedging Instruments, Statement of Financial Accounting Standards, June 1998, Financial Accounting Standards Board: Norwalk, CT.

FASB (2000a), Accounting for Certain Derivative Instruments and Certain Hedging Activities: an amendment of FASB Statement No. 133, Proposed Statement of Financial Accounting Standards, March 2000, Financial Accounting Standards Board: Norwalk, CT.

FASB (2000b), CON 7: Using Cash Flow Information and Present Value in Accounting Measurements, Statement of Financial Accounting Concepts, February 2000, Financial Accounting Standards Board: Norwalk, CT.

FEI (1994), Derivative Financial Instruments Accounting and Disclosure Issues, August 1994, Financial Executives Institute:.

Fligstein, Neil (1991), The Structural Transformation of American Industry: An Institutional Account of the Causes of Diversification in the Largest Firms, 1919-1979, in: Walter W. Powell and Paul J. DiMaggio (eds.), The New Institutionalism in

Organizational Analysis, pp. 311-336, The University of Chicago Press: Chicago and London.

Flower, John (1997), The Future of Harmonization: the EU versus the IASC versus the SEC, in: European Accounting Review, Vol. 6, No. 2, pp. 281-303.

Foucault, Michel (1979), On Governmentality, in: I & C, Vol. 6, pp. 5-22.

Francis, Jere R. (1987), Lobbying Against Proposed Accounting Standards: The Case of Employers' Pension Accounting, in: Journal of Accounting and Public Policy, Vol. 6, pp. 35-57.

G-30 (1993), Derivatives: Practices and Principles, July 1993, The Group of Thirty: Washington DC.

Galbraith, John K. (1961), The Great Crash 1929, Time Inc: New York.

GAO (1994), Financial Derivatives: Actions Needed to Protect the Financial System, Report to Congressional Requesters, May 1994, United States General Accounting Office: Washington.

GAO (1996), Financial Derivatives: Actions Taken or Proposed Since May 1994, November 1996, General Accounting Office: Washington.

Giddens, Anthony (1979), Central Problems in Social Theory: Action, Structure and Contradiction in Social Analysis, University of California Press: Berkeley.

Giddens, Anthony (1984), The Constitution of Society: Outline of the Theory of Structuration, Polity Press: Cambridge.

Goodfellow, James L. (1988), Evaluation of Assets and Liabilities and Income Recognition: Comments, in: OECD (ed.), New Financial Instruments: Disclosure and Accounting, pp. 219-229, Organisation for Economic Co-Operation and Development: Paris.

Goodhart, Charles A.E. (1995), The Regulatory Debate in London, in: Charles A.E. Goodhart (ed.), The Central Bank and the Financial System, pp. 430-439, First published in 1988 as LSE Financial Markets Group, Special Paper Series 007, Macmillan Press: London.

Granovetter, Mark (1992), Economic Action and Social Structure: The Problem of Embeddedness, in: Mark Granovetter and Richard Swedberg (eds.), The Sociology of Economic Life, pp. 53-81, Westview Press: Oxford.

Griffin, Paul A. and Richard P. II Castanias (1987), Accounting for the Translation of Foreign Currencies: The Effects of Statement 52 on Equity Analysts, Financial Accounting Standards Board:.

Griffith, Ian (1986), Creative Accounting: How to make your profits what you want them to be, Routledge: London.

Grinyer, John R. and A. Russell (1992), National Impediments to International Harmonization: Evidence of Lobbying in the UK, in: Journal of International Accounting, Auditing and Taxation, Vol. 1, No. 1, pp. 13-31.

Guay, Wayne R. (1999), The Impact of Derivatives on Firm Risk: An Empirical Examination of New Derivative Users, in: Journal of Accounting and Economics, Vol. 26, pp. 319-351.

Gup, Benton E. (1998), Bank Failures in the Major Trading Countries of the World: Causes and Remedies, Quorum Books: London.

Hancher, Leigh and Michael Moran (1989), Organizing Regulatory Space, in: Leigh Hancher and Michael Moran (eds.), Capitalism, Culture and Regulation, pp. 271-

299, Clarendon Press: Oxford.

Hardwick, Philip and Mike Adams (1999), The Determinants of Financial Derivatives Use in the United Kingdom Life Insurance Industry, in: Abacus, Vol. 35, No. 2, pp. 163-184.

Haring, John R. (1979), Accounting Rules and "The Accounting Establishment", in: Journal of Business, Vol. 52, No. 4, pp. 507-519.

Hicks, John R. (1939), Value and Capital: An Inquiry Into Some Fundamental Principles of Economic Theory, Clarendon Press: Oxford.

Hines, Ruth D. (1988), Financial Accounting: In Communicating Reality, We Construct Reality, in: Accounting, Organizations and Society, Vol. 13, No. 3, pp. 251-261.

Hope, Tony and John Briggs (1982), Accounting Policy Making - Some Lessons from the Deferred Taxation Debate, in: Accounting and Business Research, Vol. 12, Spring 1982, pp. 83-96.

Hope, Tony and Rob Gray (1982), Power and Policy Making: The Development of an R&D Standard, in: Journal of Business Finance & Accounting, Vol. 9, No. 4, pp. 531-558.

Hopwood, Anthony (1983), Accounting Research and Accounting Practice: The Ambiguous Relationship Between the Two, The Deloitte, Haskins & Sells Accounting Lectures, University College of Wales: Aberystwyth.

Hopwood, Anthony (1987), The Archaeology of Accounting Systems, in: Accounting, Organizations and Society, Vol. 12, No. 3, pp. 207-234.

Hopwood, Anthony G. and Peter Miller (eds.) (1994), Accounting as Social and Institutional Practice, Cambridge University Press: Cambridge, UK.

Horton, Joanne and Richard Macve (1995), Accounting Principles for Life Insurance: A True and Fair View?, Institute of Chartered Accountants in England and Wales: London.

Huntington, Samuel P. (1952), The Marasmus of the ICC: The Commission, the Railroads, and the Public Interest, in: Yale Law Journal, Vol. 61, pp. 467-509.

Hussein, Mohamed E. and J. Edward Ketz (1980), Ruling Elites of the FASB: A Study of the Big Eight, in: Journal of Accounting, Auditing and Finance, Summer 1980, pp. 354-367.

Hussein, Mohamed E. and J. Edward Ketz (1991), Accounting Standard-Setting in the U.S.: An Analysis of Power and Social Exchange, in: Journal of Accounting and Public Policy, Vol. 10, pp. 59-81.

Hutter, Bridget M. (1993), Regulation: Standard Setting and Enforcement, in: Law and Society Review, Vol. 27, No. 1, pp. 233-248.

IASC (1977), E11 - Accounting for Foreign Transactions and Translation of Foreign Financial Statements, International Accounting Standards Committee: London.

IASC (1980), Disclosures in Financial Statements of Banks, Discussion Paper, March 1980, International Accounting Standards Committee: London.

IASC (1982), IAS 17 - Accounting for Leases, International Accounting Standard, September 1982, International Accounting Standards Committee: London.

IASC (1983), IAS 21 - Accounting for the Effects of Changes in Foreign Exchange Rates, International Accounting Standards Committee: London.

IASC (1985), IAS 25 - Accounting for Investments, International Accounting Standard, March 1986, International Accounting Standards Committee: London.

IASC (1988), Framework for the Preparation and Presentation of Financial Statements (Framework), Exposure Draft, May 1988, International Accounting Standards Committee: London.

IASC (1989a), E32 - Comparability of Financial Statements, Exposure Draft, January 1989, International Accounting Standards Committee: London.

IASC (1989b), E34 - Disclosures in the Financial Statements of Banks and Similar Financial Institutions, Exposure Draft, July 1989, International Accounting Standards Committee: London.

IASC (1989c), Framework for the Preparation and Presentation of Financial Statements, April 1989, International Accounting Standards Committee: London.

IASC (1990a), DSOP - Financial Instruments, Draft Statement of Principles, November 1990, International Accounting Standards Committee: London.

IASC (1990b), IAS 30 - Disclosures in the Financial Statements of Banks and Similar Financial Institutions, International Accounting Standard, August 1990, International Accounting Standards Committee: London.

IASC (1991), E40 - Financial Instruments, Exposure Draft, September 1991, International Accounting Standards Committee: London.

IASC (1992), E44 - The Effects of Changes in Foreign Exchange Rates, Exposure Draft, May 1992, International Accounting Standards Committee: London.

IASC (1993a), E40, Financial Instruments - Progress Report, in: IASC Insight, Special Edition, May 1993, pp. 1-16.

IASC (1993b), IAS 21 (revised) - The Effects of Changes in Foreign Exchange Rates, International Accounting Standard, December 1993, International Accounting Standards Committee: London.

IASC (1994), E48 - Financial Instruments, Exposure Draft, January 1994, International Accounting Standards Committee: London.

IASC (1995), IAS 32 - Financial Instruments: Disclosure and Presentation, International Accounting Standard, May 1995, International Accounting Standards Committee: London.

IASC (1997a), Accounting for Financial Assets and Financial Liabilities, Discussion Paper, March 1997, International Accounting Standards Committee: London.

IASC (1997b), IAS 17 (revised) - Leases, International Accounting Standard, April 1997, International Accounting Standards Committee: London.

IASC (1998a), E62 Proposed International Accounting Standard - Financial Instruments: Recognition and Measurement, Exposure Draft, June 1998, International Accounting Standards Committee: London.

IASC (1998b), Shaping IASC for the Future, Discussion Paper, December 1998, International Accounting Standard Committee: London.

IASC (1999), IAS 39 Financial Instruments: Recognition and Measurement, International Accounting Standard, March 1999, International Accounting Standards Committee: London.

ICAEW (1975), The Corporate Report: A Discussion Paper, published for comment by the Accounting Standards Steering Committee, Institute of Chartered Accountants in England and Wales, Accounting Standards Steering Committee: London.

ICAEW (1985), Off Balance Sheet Financing and Window Dressing, Technical Release

603, December 1985, Institute of Chartered Accountants in England and Wales: London.

Jackson, Howell E. (1997), Strategies for Regulating Risk in Financial Intermediaries, in: Clifford E. Kirsch (ed.), The Financial Services Revolution: Understanding the Changing Role of Banks, Mutual Funds, and Insurance Companies, pp. 527-550, Irwin Professional Publisher: Chicago.

Johnson, L. Todd (1994), Future Events: A Conceptual Study of Their Significance for Recognition and Measurement, Financial Accounting Series, Special Report, Financial Accounting Standards Board: Norwalk, CT.

Johnson, L. Todd and Andrew Lennard (1998), Reporting Financial Performance: Current Developments and Future Directions, G4+1 Special Report, January 1998, Financial Accounting Standards Board: Norwalk, CT.

Johnson, Steven B. and William F. Jr. Messier (1982), The Nature of Accounting Standard Setting: An Alternative Explanation, in: Journal of Accounting, Auditing and Finance, Spring 1982, pp. 195-213.

Johnson, Steven B. and David Solomons (1984), Institutional Legitimacy and the FASB, in: Journal of Accounting and Public Policy, Vol. 3, No. 3, pp. 165-183.

JPMorgan/Reuters (1996), RiskMetrics — Technical Document, 4th Edition, Morgan Guaranty Trust Company: New York.

Kariel, Henry S. (1961), The Decline of American Pluralism, Stanford University Press: Stanford.

Kelly, Lauren (1982), Corporate Lobbying and Changes in Financing or Operating Activities in Reaction to FAS No. 8, in: Journal of Accounting and Public Policy, Vol. 1, No. 2, pp. 153-173.

Kelly, Lauren (1985), Corporate Management Lobbying on FAS No. 8: Some Further Evidence, in: Journal of Accounting Research, Vol. 23, No. 2, pp. 619-632.

Kenny, Sara Y. and Robert K. Larson (1993), Lobbying Behaviour and the Development of International Accounting Standards: The Case of the IASC's Joint Venture Project, in: European Accounting Review, Vol. 3, pp. 206-229.

Kirsch, Robert J., Thomas G. Evans, and Timothy S. Doupnik (1990), FASB Statement 52, an Accounting Policy Intervention: U.S.-Based Multinational Corporate Preenactment Lobbying Behavior, in: Kenneth Most (ed.), Advances in International Accounting, Vol. 3, pp. 155-171, JAI Press: London.

KPMG (1995), Financial Instruments: Einsatzmöglichkeiten, Risikomanagement und Risikocontrolling, Rechnungslegung, Besteuerung, KPMG Deutschland.

Kuhn, Thomas S. (1962), The Structure of Scientific Revolutions, University of Chicago Press: Chicago.

Larson, Robert K. (1997), Corporate Lobbying of the International Accounting Standards Committee, in: Journal of International Financial Management and Accounting, Vol. 8, No. 3, pp. 175-203.

Latour, Bruno (1987), Science in Action: How to Follow Scientists and Engineers through Society, Harvard University Press: Cambridge, Massachusetts.

Latour, Bruno (1996), Aramis or the Love of Technology, Harvard University Press: Cambridge, MA.

Law Society (1986), Off-Balance Sheet Finance and Window Dressing, Memorandum by the Society's Standing Committee on Company Law, Law Society: London.

Lennard, Andrew and Sandra Thompson (1995), Provisions: Their Recognition, Measurement, and Disclosure, G4+1 Special Report, November 1995, Financial Accounting Standards Board: Norwalk, CT.

Littleton, A. C. (1948), Fixed Assets and Accounting Theory, in: Illinois Certified Public Accountant, Vol. 10, pp. 11-18.

Luhmann, Niklas (1993), Risk : A Sociological Theory, translated by: Rhodes Barrett, A. de Gruyter: New York.

Luhmann, Niklas (1995), Social Systems, translated by: Bednarz, John Jr. with Dirk Baecker, Stanford University Press: Stanford, California.

MacArthur, John B. (1996), An Investigation into the Influences of Cultural Factors in the International Lobbying of the International Accounting Standards Committee: The Case of E32, Comparability of Financial Statements, in: International Journal of Accounting, Vol. 31, No. 2, pp. 213-237.

Macve, Richard (1981), A Conceptual Framework for Financial Accounting and Reporting, Institute of Chartered Accountants in England and Wales: London.

Macve, Richard (1983), The FASB's Conceptual Framework - Vision, Tool or Threat?, The University College of Wales: Aberystwyth.

Macve, Richard (1984), Accounting for long-term loans, in: Bryan Carsberg and Susan Dev (eds.), External Financial Reporting, pp. 90-108, Prentice-Hall: London.

Macve, Richard and Jonathan Jackson (1991), 'Marking to Market': Accounting for Marketable Securities in the Financial Services Industry, Research Paper, Research Board of ICAEW.

Macve, Richard and Keith Wild (1999), Actuaries v Accountants, in: Accountancy, December 1999, pp. 78-80.

Mahoney, Jeffrey P. and Yoshinori Kawamura (1995), Review of 1994 Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments, Special Report, December 1995, Financial Accounting Standards Board: Norwalk, CT.

March, James G. and Johan P. Olsen (1989), Rediscovering Institutions: The Organizational Basis of Politics, Free Press: New York.

Markowitz, Harry M. (1959), Portfolio Selection: Efficient Diversification of Investment, Cowles Foundation Monograph 16, Yale University Press: New Haven, CT.

Marsh, David (ed.) (1998), Comparing Policy Networks, Open University Press: Philadelphia, PA.

Mattessich, Richard (1957), Towards a General and Axiomatic Foundation of Accountancy, in: Accounting Research, Vol. 8, No. 4, pp. 328-355.

Mattessich, Richard (1964), Accounting and Analytical Methods: Measurement and Projection of Income and Wealth in the Micro- and Macro-Economy, Scholars Book Co: Houston, Texas.

Mattessich, Richard (1980), On the Evolution of Theory Construction in Accounting: A Personal Account, in: Accounting and Business Research, Vol. 10, pp. 158-173.

McBarnet, Doreen and Christopher Whelan (1991), The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control, in: The Modern Law Review, pp. 838-873.

McBarnet, Doreen and Christopher Whelan (1999), Creative Accounting and the Cross-Eyed Javelin Thrower, John Wiley & Sons: Chicester.

McGregor, Warren (1996), Accounting for Leases: A New Approach, Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts, G4+1 Special Report, July 1996, Financial Accounting Standards Board: Norwalk, CT.

McLeay, Stuart (ed.) (1999), Accounting Regulation in Europe, Macmillan Press: London.

McLeay, Stuart, Dieter Ordelheide, and Steven Young (2000), Constituent Lobbying and its Impact on the Development of Financial Reporting Regulations: Evidence from Germany, in: Accounting, Organizations and Society, Vol. 25, pp. 79-98.

Merino, Barbara D. and Marilyn D. Neimark (1982), Disclosure Regulation and Public Policy - A Sociohistorical Reappraisal, in: Journal of Accounting and Public Policy, Vol. 1, pp. 33-57.

Mian, Shehzad L. (1996), Evidence on Corporate Hedging Policy, in: Journal of Financial and Quantitative Analysis, Vol. 31, No. 3, pp. 419-439.

Mian, Shehzad L. and Clifford W. Jr. Smith (1990), Incentives Associated with Changes in Consolidated Reporting Requirements, in: Journal of Accounting and Economics, Vol. 13, No. 3, pp. 249-266.

Michels, Robert (1959), Political Parties: A Sociological Study of the Oligarchical Tendencies of Modern Democracy, Dover: New York.

Milburn, Alex J. (1988a), Incorporating the Time Value of Money within Financial Accounting, Canadian Institute of Chartered Accountants: Toronto.

Milburn, John Alexander (1988b), Incorporating the Time Value of Money within Financial Accounting, Research Study, Canadian Institute of Chartered Accountants: Toronto.

Milburn, John Alexander (1991), Building a Better Conceptual Framework, in: CA Magazine, Vol. 124, No. 12, Dec 1991, pp. 43-48.

Miller, Peter (1997), The Multiplying Machine, in: Accounting, Organizations and Society, Vol. 22, No. 3/4, pp. 355-364.

Miller, Peter (1998), The Margins of Accounting, in: European Accounting Review, Vol. 7, pp. 605-662.

Miller, Peter and Ted O'Leary (1993), Accounting Expertise and the Politics of the Product: Economic Citizenship and Modes of Corporate Governance, in: Accounting, Organizations and Society, Vol. 18, No. 2/3, pp. 187-206.

Miller, Peter and Michael Power (1992), Accounting, Law and Economic Calculation, in: Michael Bromwich and Anthony Hopwood (eds.), Accounting and the Law, pp. 230-253, Prentice Hall: Oxford.

Miller, Peter and Michael Power (1995), Calculating corporate failure, in: Yvez Dezalay and David Sugarman (eds.), Professional Competition and Professional Power, pp. 51-76, Routledge: London.

Miller, Peter and Nikolas Rose (1990), Governing Economic Life, in: Economy and Society, Vol. 19, No. 1, pp. 1-31.

Miller, Paul B.W., Rodney J. Redding, and Paul R. Bahnson (1998), The FASB: The People, the Process, and the Politics, 4th Edition, Irwin/McGraw Hill: Burr Ridge, IL.

Montagna, Paul D. (1974a), Certified Public Accountancy: A Sociological View of a Profession in Change, Scholars Book Co: Houston.

Montagna, Paul D. (1974b), Public Accounting: The Dynamics of Occupational Change, in: Robert R. Sterling (ed.), Institutional Issues in Public Accounting: Papers and

Responses from Accounting Colloquium III, pp. 3-24, Scholars Book Co: Lawrence, Kansas.

Moonitz, Maurice (1961), The Basic Postulates of Accounting, Accounting Research Study No. 1, American Institute of Certified Public Accountants: New York.

Moonitz, Maurice (1974), Obtaining Agreement on Standards in the Accounting Profession, American Accounting Association:.

Napier, Christopher and Christopher Noke (1992), Accounting and Law: An Historical Overview of an Uneasy Relationship, in: Michael Bromwich and Anthony Hopwood (eds.), Accounting and the Law, pp. 30-54, Prentice Hall and ICAEW: London.

Napier, Christopher and Michael Power (1992), Professional Research, Lobbying and Intangibles: A Review Essay, in: Accounting and Business Research, Vol. 23, No. 89, pp. 85-95.

Nelson, Jane F. (1984), The Regulatory Debate on Capital Continues, in: United States Banker, Vol. 95, No. 1, January 1984, pp. 20-24.

North, Douglas (1981), Structure and Change in Economic History, W. W. Norton & Company: New York.

OECD (1987), Off-Balance Sheet Financial Instruments: Implications for Accounting and Financial Reporting by Banks, Organisation for Economic Co-operation and Development, Committee on International Investment and Multinational Enterprises, Working Group on Accounting Standards: Paris.

OECD (1988), New Financial Instruments: Disclosure and Accounting, Organization for Economic Co-operation and Development: Paris.

Olson, Mancur (1971), The Logic of Collective Action, Harvard University Press: Cambridge, MA.

Paish, F. W. (1977), Capital Value and Income, in: William Baxter and S. Davidson (eds.), Studies in Accounting, pp. 179-181, first published in Economica (November 1940), pp. 416-418, Institute of Chartered Accountants in England and Wales: London.

Paterson, John (1997), Behind the Mask: Regulating Health and Safety in British Offshore Oil and Gas Industry, PhD Dissertation, Florence.

Paton, William A. and Ananias C. Littleton (1940), An Introduction to Corporate Accounting Standards, American Accounting Association: Urbana, Illinois.

Paul, Jim (1997), International Review of Accounting Standards Specifying a Recoverable Amount Test for Long-Lived Assets, G4+1 Special Report, October 1997, Financial Accounting Standards Board: Norwalk, CT.

Peirce, Charles S. (1957), Essays in the Philosophy of Science, Liberal Arts Press: New York.

Pickering, George (1999), Ongoing Challenges for Setting and Establishing International Banking Standards, Paper presented at the Conference on the New International Financial Architecture, 4 June 1999, University of Hong Kong: Hong Kong.

Polanyi, Karl (1992), The Economy as Instituted Process, in: Mark Granovetter and Richard Swedberg (eds.), The Sociology of Economic Life, pp. 29-51, Westview Press: Oxford.

Pong, Christopher K.M. (1999), Jurisdictional contests between accountants and lawyers: the case of off-balance sheet finance 1985-1990, in: Accounting History, Vol. 4, No. 1, pp. 7-29.

Popper, Karl R. (1972), Objective Knowledge: An Evolutionary Approach, Oxford University Press: Oxford.

Posner, Richard A. (1974), Theories of Economic Regulation, in: Bell Journal of Economics and Management Science, Autumn 1974, pp. 335-358.

Power, Michael (1992), The Politics of Brand Accounting in the United Kingdom, in: European Accounting Review, Vol. 1, No. 1, pp. 39-68.

Power, Michael (1993), On the Idea of a Conceptual Framework for Financial Reporting, in: Michael J. Mumford and Ken V. Peasnell (eds.), Philosophical Perspectives on Accounting: Essays in Honour of Edward Stamp, pp. 44-61, Routledge: London.

Power, Michael (1994), Constructing the Responsible Organization: Accounting and Environmental Representation, in: Gunther Teubner, Lindsay Farmer, and Declen Murphy (eds.), Environmental Law and Ecological Responsibility, pp. 369-392, John Wiley & Sons: London.

Power, Michael (1996), Social Theories of Financial Accounting, in:, International Encyclopaedia for Business and Management, Vol. 2, pp. 1421-1433, Routledge: London.

Power, Michael (1997), Academics in the Accounting Policy Process: England and Germany Compared, in: John Flower and Christian Lefebvre (eds.), Comparative Studies in Accounting Regulation in Europe, pp. 113-126, ACCO: Leuven.

Puro, Marsha (1984), Audit Firm Lobbying before the Financial Accounting Standards Board: An Empirical Study, in: Journal of Accounting Research, Vol. 22, No. 2, pp. 624-646.

Puro, Marsha (1985), Do Large Accounting Firms Collude in the Standards-Setting Process?, in: Journal of Accounting, Auditing and Finance, Vol. 8, No. 3, pp. 165-177.

Robb, Fenton F. (1991), Accounting - A Virtual Autopoietic System?, in: Systems Practice, Vol. 4, No. 3, pp. 215-235.

Robson, Keith (1988), Accounting, the State and the Regulatory Process: The Case of Standard Setting 1969-1975, PhD Dissertation, Faculty of Technology: Manchester, UK.

Robson, Keith (1991), On the Arenas of Accounting Change: The Process of Translation, in: Accounting, Organizations and Society, Vol. 16, No. 5/6, pp. 547-570.

Robson, Keith (1994a), Connecting Science to the Economic: Accounting Calculation and the Visibility of Research and Development, in: Michael Power (ed.), Accounting and Science: Natural Inquiry and Commercial Reason, pp. 151-169, Cambridge University Press: Cambridge, UK.

Robson, Keith (1994b), The Discourse of Inflation Accounting: On the Interrelations Between Economic Theory and Debates on Inflation Accounting, in: European Accounting Review, Vol. 3, No. 2, pp. 195-214.

Robson, Keith (1994c), Inflation Accounting and Action at a Distance: The Sandilands Episode, in: Accounting, Organizations and Society, Vol. 19, No. 1, pp. 45-82.

Robson, Keith, Hugh Willmott, David Cooper, and Tony Puxty (1994), The Ideology of Professional Regulation and the Markets for Accounting Labour: Three Episodes in the Recent History of the U.K. Accountancy Profession, in: Accounting, Organizations and Society, Vol. 19, No. 6, pp. 527-553.

Ross, Howard I. (1967), The Current Crisis in Financial Reporting, in: Journal of

Accountancy, Vol. 124, pp. 65-69.

Rutherford, B. A. (1988), The Doctrine of Substance over Form, Research Report No. 11, The Chartered Association of Certified Accountants: London.

SEC (1996), Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, Release No. 7250; December 28, 1995; FR-578, January 8, 1996, Securities and Exchange Commission: Washington, D.C.

SEC (1997), Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information about Market Risk Inherent in Derivative Financial Instruments, other Financial Instruments, and Derivative Commodity Instruments, Release Nos. 33-7386; 34-38223; IC-22487; FR-48; International Series No. 1047; File No. S7-35-95, January 31, 1997, Securities and Exchange Commission: Washington, D.C.

Shah, Atul K. (1996), Creative Compliance in Financial Reporting, in: Accounting, Organizations and Society, Vol. 21, No. 1, pp. 23-39.

Sharpe, William F. (1970), Portfolio Theory and Capital Markets, McGraw-Hill: New York.

Singer, Otto (1990), Policy Communities and Discourse Coalitions, in: Knowledge: Creation, Diffusion, Utilization, Vol. 11, No. 4, pp. 428-458.

Smith, Clifford W., Charles W. Smithson, and D. Sykes Wilford (1989), Managing Financial Risk, in: The Continental Bank Journal of Applied Corporate Finance, Vol. 1, No. 4,.

Smith, Clifford W. and Rene M. Stulz (1985), The Determinants of Firms' Hedging Policies, in: Journal of Financial and Quantitative Analysis, Vol. 20, No. 4, pp. 391-405.

Smith, Terry (1992), Accounting for Growth: Stripping the Camouflage from Company Accounts, Century Business Publications: London.

Solomons, David (1986), The FASB's Conceptual Framework: an Evaluation, in: Journal of Accountancy, Vol. 116, No. 6, pp. 114-124.

Spiller, Earl A. Jr. (1964), Theory and Practice in the Development of Accounting, in: The Accounting Review, Vol. 34, pp. 850-859.

Sprouse, Robert T. (1987), Commentary on Financial Reporting, in: Accounting Horizons, Vol. 1, pp. 104-108.

Stephens, Ray G., Jesse F. Dillard, and David K. Dennis (1985), Implications of Formal Grammars for Accounting Policy Development, in: Journal of Accounting and Public Policy, Vol. 4, No. 2, pp. 123-148.

Stewart, John E. (1989), The Challenges of Hedge Accounting, in: Journal of Accountancy, November 1989, pp. 48-56.

Stigler, George J. (1971), The Theory of Economic Regulation, in: Bell Journal of Economics and Management Science, Vol. 2, No. 3, pp. 3-21.

Strauss, Anselm and Juliet Corbin (1998), Basics of Qualitative Research: Techniques and Procedures for Developing Grounded Theory, Sage Publications: London.

Street, Donna L. and Kimberley A. Shaughnessy (1998), The Evolution of the G4+1 and Its Impact on International Harmonization of Accounting Standards, in: Journal of International Accounting, Auditing & Taxation, Vol. 7, No. 2, pp. 131-161.

Stulz, Rene M. (1984), Optimal Hedging Policies, in: Journal of Financial and Quantitative Analysis, pp. 127-140.

Sunder, Shyam (1997), Theory of Accounting and Control, South-Western Publishing: Cincinnati, Ohio.

Sutton, Timothy G. (1984), Lobbying of Accounting Standard-setting Bodies in the U.K. and the U.S.A.: A Downsian Analysis, in: Accounting, Organizations and Society, Vol. 9, No. 1, pp. 81-95.

Sutton, Timothy G. (1988), The Proposed Introduction of Current Cost Accounting in the UK: Determinants of Corporate Preference, in: Journal of Accounting and Economics, Vol. 10, pp. 127-149.

Tandy, Paulette R. and Nancy L. Wilburn (1992), Constituent Participation in Standard-Setting: the FASB's First 100 Statements, in: Accounting Horizons, Vol. 6, No. 2, June 1992, pp. 47-58.

Teubner, Gunther (1993), Law as an Autopoietic System, Basil Blackwell: Oxford.

Tinker, Tony and Tony Puxty (1995), Policing Accounting Knowledge: The Market for Excuses Affair, Paul Chapman: London.

Tweedie, David (1993), The Accounting Profession and Financial Reporting: Why Should Anyone Believe Us?, in: Research in Accounting Regulation, Vol. 7, pp. 161-182.

Tweedie, David (1996), The Conceptual Framework and the Accounting Standards Board, in: Irvine Lapsley (ed.), Essays in Accounting Thought: A Tribute to W.T. Baxter, pp. 41-67, Institute of Chartered Accountants of Scotland: Edinburgh.

Tweedie, David and Geoffrey Whittington (1984), The Debate on Inflation Accounting, Cambridge University Press: Cambridge.

Tweedie, David and Geoffrey Whittington (1990), Financial Reporting: Current Problems and Their Implications for Systematic Reform, in: Accounting and Business Research, Vol. 21, pp. 87-102.

Tweedie, David and Geoffrey Whittington (1997), The End of the Current Cost Revolution, in: T. E. Cooke and C. W. Nobes (eds.), The Development of Accounting in an International Context: A Festschrift in Honour of R.H. Parker, pp. 149-176, Routledge: London.

US-Senate (1977), The Accounting Establishment: A Staff Study, March 1977, Prepared by the Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations, 95th Congress, 1st Session, United States Senate: Washington.

US-Treasury (1991), Modernizing the financial system: recommendations for safer, more competitive banks, February 1991, United States, Department of the Treasury: Washington, D.C.

Van Riper, Robert (1994), Setting Standards for Financial Reporting: FASB and the Struggle for Control of a Critical Process, Quorum Books: Westport, CT.

Vieten, Holger R. (1996), Banking Regulation in Britain and Germany Compared: Capital Ratios, External Audit and Internal Control, PhD Dissertation, London School of Economics and Political Science: London.

Vietze, Axel and Mike Chatham (1998), The IASC Financial Instruments Discussion Paper: An Examination of the Lobbying Behaviour,.

Walker, Robert G. and Peter Robinson (1993), A Critical Assessment of the Literature on Political Activity and Accounting Regulation, in: Research in Accounting

Regulation, Vol. 7, pp. 3-40.

Watts, Ross L. and Jerold L. Zimmerman (1978), Towards a Positive Theory of the Determination of Accounting Standards, in: The Accounting Review, Vol. 53, No. 1, pp. 112-134.

Watts, Ross L. and Jerold L. Zimmerman (1979), The Demand for and Supply of Accounting Theories: The Market for Excuses, in: The Accounting Review, Vol. 54, No. 2, pp. 273-305.

Willett, R.J. (1987), An Axiomatic Theory of Accounting, in: Accounting and Business Research, Spring 1987, pp. 155-171.

Young, Joni J. (1994), Outlining Regulatory Space: Agenda Issues and the FASB, in: Accounting, Organization and Society, Vol. 19, No. 1, pp. 83-109.

Young, Joni J. (1995), Getting the Accounting 'Right': Accounting and the Savings and Loan Crisis, in: Accounting, Organizations and Society, Vol. 20, No. 1, pp. 55-80.

Young, Joni J. (1996), Institutional Thinking: the Case of Financial Instruments, in: Accounting, Organizations and Society, Vol. 21, No. 5, pp. 487-512.

Zeff, Stephen A. (1972), Forging Accounting Principles in Five Countries: A History and an Analysis of Trends, Arthur Andersen & Co. Lecture Series, Stipes Publishing Company: Champaign, Illinois.

Zeff, Stephen A. (1974), Comments on Accounting Principles - How They are Developed, in: Robert R. Sterling (ed.), Institutional Issues in Public Accounting, pp. 172-178, Scholars Book Co: Kansas.

Zeff, Stephen A. (1978), The Rise of "Economic Consequences", in: Journal of Accountancy, Vol. 146, No. 6, pp. 56-63.

Zeff, Stephen A. (1986), Big Eight Firms and the Accounting Literature: The Falloff in Advocacy Writing, in: Journal of Accounting, Auditing and Finance, Vol. 1, No. 2, pp. 131-154.

Zeff, Stephen A. (1993), The Politics of Accounting Standards, in: Economia Aziendale, Vol. 12, No. 2, pp. 123-142.

Zeff, Stephen A. (1995), Commentary: A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting, in: Accounting Horizons, March 1995, pp. 52-70.

Zeff, Stephen A. (1997), Playing the Congressional Card on Employee Stock Options: A Fearful Escalation in the Impact of Economic Consequences Lobbying on Standard Setting, in: T. E. Cooke and C. W. Nobes (eds.), The Development of Accounting in an International Context: A Festschrift in Honour of R. H. Parker, pp. 177-192, Routledge: London.

Zeff, Stephen A. (1998), The Coming Confrontation on International Accounting Standards, in: Irish Accounting Review, Vol. 5, No. 2, pp. 89-117.

Appendices

A1: Abbreviations

AAA	American Accounting Association
AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
AICPA	American Institute of Certified Public Accountants
ASC	Accounting Standards Committee (U.K.), which formulated SSAPs for approval by councils of accountancy bodies until August 1991
ASB	Accounting Standards Board (U.K.), since 1990 successor to the ASC, issuing FRSs
APB	Accounting Principles Board of the AICPA, which issued APB Opinions between 1962 and 1973
ARB	Accounting Research Bulletins issued by the Committee on Accounting Procedure of the AICPA until 1959
BBA	British Bankers' Association
BIS	Bank for International Settlements
CCAB	Consultative Committee of Accountancy Bodies (U.K.), consisting of five professional accountancy bodies including the ICAEW as well as the Scottish and Irish institutes.
CICA	Canadian Institute of Chartered Accountants
CON	Concept Statement issued by the FASB
DP	Discussion Paper issued by the IASC or the ASB
DSOP	Draft Statement of Principles
Exx	Exposure Draft number xx issued by the IASC
EC	Council of the European Commission
ED	Exposure Draft issued by the ASC
EU	European Union
E&Y	Ernst & Young
FASB	Financial Accounting Standards Board (U.S.), since 1973 successor of the APB, issuing SFASs
FEE	Fédération des Experts Comptables Européens
FEI	Financial Executives Institute
FFI	Fundamental Financial Instruments
FRED	Financial Reporting Exposure Draft issued by the ASB
FRS	Financial Reporting Standard issued by the ASB
FT	Financial Times
G4	Group of Four and
G4+1	Group of Four plus One, a grouping initially set up in 1993 by four independent standard setting bodies from Australia, Canada, United Kingdom and United States plus the IASC
G-30	Group of Thirty, an international group of banking representatives
GAAP	Generally Accepted Accounting Principles (U.S.) / Practice (U.K.)
GAO	General Accounting Office (U.S.)
GASB	Governmental Accounting Standards Board (U.S.)
IAS	International Accounting Standard
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants in England and Wales
IFAC	International Federation of Accountants
IOSCO	International Organisation of Securities Commissions
JWG	Joint Working Group on Financial Instruments, since 1997 including major national standard setters and the IASC

KPMG	KPMG Peat Marwick
LIBOR	London Inter-Bank Offering Rate, a benchmark interest rate
OECD	Organisation for Economic Co-operation and Development
SEC	Securities and Exchange Commission (U.S.)
SFA	Securities and Futures Authority (U.K.)
SFAS	Statement of Financial Accounting Standard issued by the FASB
SORP	Statement of Recommended (Accounting) Practice, for example issued by the BBA
SSAP	Statement of Standard Accounting Practice, formulated by ASC and issued by the CCAB until 1990
U.K.	United Kingdom
U.S.	United States of America
VAR	Value at Risk

A2: Interviews

The following table A2.1 contains a list of those interviews that have been recorded and fully transcribed. For reasons of confidentiality, a full list of interview partners is only available from the author on request. The research is also based on many short interviews and discussions, which were either not recorded or not fully transcribed. Information has also been gathered through email correspondence, telephone conversations, letters and feedback to various drafts of the thesis.

Table A2.1: List of transcribed interviews

No	Date	Affiliation of interview partners
A	15 January 1998	Corporation and national accounting standard setter
B	2 February 1998	Corporation
C	27 February 1998	Corporation
D	13 March 1998	Corporation
E	8 April 1998	Corporation
F	8 April 1998	National standard setter
G	11 June 1998	International standard setter
H	29 June 1998	International standard setter
I	17 July 1998	International standard setter
J	20 July 1998	International standard setter
K	22 July 1998	Accounting firm
L	30 July 1998	Newspaper
M	4 August 1998	Industry representation
N	7 August 1998	International standard setter
O	12 August 1998	Accounting firm
P	19 August 1998	National standard setter
Q	21 August 1998	Industry representation
R	25 August 1998	Corporation
S	26 August 1998	Industry representation
T	14 October 1998	Professional representation
U	15 October 1998	Bank
V	30 October 1998	National standard setter
W	5 November 1998	Bank
X	27 November 1998	International standard setter
Y	15 December 1998	National standard setter
Z	16 December 1998	National standard setter

No	Date	Affiliation of interview partners
a	16 December 1998	National standard setter
b	17 December 1998	National standard setter
c	17 December 1998	Accounting firm
d	18 December 1998	Accounting firm
e	18 December 1998	National standard setter
f	15 January 1999	Bank
g	12 August 1999	Academic

A3: Major events

The following table A3.1 lists the major events and project documents related to the IASC's financial instruments project. While the focus is on the IASC's project, the project needs to be seen in the increasingly connected international context. In particular the developments in North America and in Europe need to be considered. Although the Canadian project was closely associated with the IASC endeavor, the table below will focus on the FASB's standard setting events, while the U.K. and some EU pronouncements will be considered with respect to developments in Europe.

Table A3.1: Major events related to the IASC's financial instruments project

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1973	IASC formed	FASB formed	
1974	Basle Committee on Banking Supervision formed		
1975		SFAS 5: Contingencies (FASB 1975a) SFAS 8: Translation of Foreign Currency Transactions and Foreign Currency Financial Statements (FASB 1975b) SFAS 12: Marketable Securities (FASB 1975c)	ICAEW: The Corporate Report: A Discussion Paper (ICAEW 1975)
1976		SFAS 13: Leases (FASB 1976)	ASC formed
1977	E11: Foreign Transactions and Translation of Foreign Financial Statements (IASC 1977) Start of the IASC joint project on bank disclosures with Basle Committee	SFAS 20: Forward Exchange Contracts (FASB 1977)	ED 21: Foreign Currency Transactions (ASC 1977)
1978		Report on economic impact of SFAS 8 (Evans et al. 1978)	Fourth Directive on annual accounts (EC 1978)
1980	DP: Disclosures in Financial Statements of Banks (IASC 1980)		ED 27: Foreign Currency Translations (ASC 1980)
1981		SFAS 52: Foreign Currency Translations (FASB 1981)	ED 29: Leases and Hire Purchase Contracts (ASC 1981)

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1982	IAS 17: Leases (IASC 1982)	SFAS 67: Real Estate Projects (FASB 1982)	
1983	IAS 21: Effects of Changes in Foreign Exchange Rates (IASC 1983)	SFAS 76: Extinguishment of Debt (FASB 1983a) SFAS 77: Reporting by Transferors for Transfers of Receivables with Recourse (FASB 1983b)	Seventh Directive on consolidated accounts (EC 1983) SSAP 20: Foreign currency translations (ASC 1983)
1984		SFAS 80: Futures Contracts (FASB 1984)	SSAP 21: Leases and Hire Purchase Contracts (ASC 1984)
1985	IAS 25: Investments (IASC 1985)	TB 85-2: Collateralized Mortgage Obligations (FASB 1985b) CON6: Elements of Financial Statements (FASB 1985a)	U.K. Companies' Act 1985 TR 603: Off-Balance Sheet Financing and Window Dressing (ICAEW 1985)
1986 March	Basle Committee on Banking Supervision report on banks' off-balance sheet risks (BIS 1986)		
May		Start of the FASB financial instruments project	
December		Reports on economic effects of SFAS 52 (Evans and Doupnik 1986b; Evans and Doupnik 1986a)	European Directive on banks and other financial institutions (EC 1986)
1987 November	Start of the IASC's comparability project	ED: Disclosures about Financial Instruments (FASB 1987)	
1988 March	IASC first envisages project on financial instruments		ED 42: Special Purpose Transactions (ASC 1988)
May	OECD conference on New Financial Instruments in Paris (OECD 1988)		
	ED: Framework (IASC 1988)		
June	Start of the IASC's financial instruments project		
July	Basle Capital Accord (BIS 1988)		
September			Dearing Report (CCAB 1988)
1989 January	E32: Comparability of Financial Statements (IASC 1989a)		
April	Framework (IASC 1989c)		
July	E34: Bank Disclosures (IASC 1989b)	ED (Revised): Disclosure of Information about Financial Instruments (FASB 1989)	

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1990 March		SFAS 105: Disclosure of Information about Financial Instruments (FASB 1990c)	
May			ASC ED 49: Reflecting the Substance of Transactions in Assets and Liabilities
July	Start of the IASC's improvements project		ICAEW: 'Marking to Market' (Macve and Jackson 1991)
August	IAS 30: Bank Disclosures (IASC 1990b)	DM: Distinguishing between Liabilities and Equity Instruments (FASB 1990b)	ASB formed
November	DSOP: Financial Instruments (IASC 1990a)		
December		ED: Disclosures about Market Value of Financial Instruments (FASB 1990a)	
1991 June	First annual meeting of standard setting bodies		
September	E40: Financial Instruments (IASC 1991)	Report on hedge accounting (Bierman et al. 1991)	
November	Amendment Basle Capital Accord (general provisions)		
		DM: Recognition and Measurement of Financial Instruments (FASB 1991a)	Off-Balance Sheet SORP (BBA 1991)
December		SFAS 107: Disclosures about Fair Value of Financial Instruments (FASB 1991b)	European Directive on insurance companies (EC 1991)
1992 January		FASB starts deliberating issues relating to derivatives and hedging activities	
May	E44: Changes in Foreign Exchange Rates (IASC 1992)		
June		G4 formed	
September		ED: Certain Investments in Debt and Equity Securities (FASB 1992)	
December			FRED 3: Capital Instruments (ASB 1992)
1993 February			FRED 4: Substance of Transactions (ASB 1993a)
May	E40: Financial Instruments - Progress Report (IASC 1993a)	SFAS 115: Certain Investments in Debt and Equity Securities (FASB 1993b)	

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
June		Report on hedging and other risk-adjusting activities (FASB 1993a)	
July	Banking industry paper on derivatives (G-30 1993)		
November	Presentation of G4+1 future events paper to standard setters		
	IAS 21 (revised): Changes in Foreign Exchange Rates (IASC 1993b)		
December			FRS 4: Capital Instruments (ASB 1993b)
1994 January	E48: Financial Instruments (IASC 1994)		
April		ED: Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments (FASB 1994a)	
May		GAO report on financial derivatives (GAO 1994)	
June	Meeting of standard setters to discuss E48		
August	G4+1 special report on future events (Johnson 1994)		
October		SFAS 119: Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments (FASB 1994b)	
December		Report on financial instrument disclosures (Anstis 1994)	FRS 5: Substance of Transactions (ASB 1994)
1995 April	Amendment of Basle Capital Accord (off-balance sheet items)		
May	IAS 32: Financial Instruments Disclosures (IASC 1995)		
July	IASC-IOSCO agreement to complete core standards by June 1999		
October	G4+1 report on hedge accounting (Adams and Montesi 1995)		
		ED: Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (FASB 1995)	
November	G4+1 report on provisions (Lennard and Thompson 1995)		
			European Commission on international harmonization (EC 1995)
December		Report of disclosures under SFAS 119 (Mahoney and Kawamura 1995)	

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
1996 January	Amendment of Basle Capital Accord to include market risk measures (BIS 1996)		
		SEC Proposal for market risk disclosures (SEC 1996)	
June		ED: Derivatives and hedging activities (FASB 1996a)	
		SFAS 125: Transfers of financial assets and liabilities (FASB 1996b)	
July	G4+1 Report on leases (McGregor 1996)		
			DP: Derivatives and Other Financial Instruments (ASB 1996)
November	IASC-U.S. Comparison Project (Bloomer 1996)		
		GAO report on derivatives (GAO 1996)	
1997 January		SEC FR-48: Market risk disclosures (SEC 1997)	
March	DP: Financial assets and financial liabilities (IASC 1997a)		
April	IAS 17 (revised): Leases (IASC 1997b)		FRED 13: Derivatives and Other Financial Instruments Disclosures (ASB 1997a)
June		ED: Cash Flow Information in Accounting Measurement (FASB 1997b)	
July			FRED 13 Supplement: Disclosures by Banks (ASB 1997b)
August		ED (Revised): Derivatives and Hedging Activities (FASB 1997a)	
October	G4+1 report on recoverable amount test for long-lived assets (Paul 1997)		
November	Joint Working Group on Financial Instruments established		
1998 January	G4+1 report on reporting financial performance (Johnson and Lennard 1998)		
			European Commission interpretation of 4th and 7th Council Directives (EC 1998)
June	E62: Financial Instruments: Recognition and Measurement (IASC 1998a)	SFAS 133: Derivatives and Hedging Instruments (FASB 1998b); report on investment community interest in reporting fair values of financial instruments (FASB 1998a)	

Date	International (focus on the IASC)	North America (focus on the FASB)	Europe (focus on U.K.)
September			FRS 13 - Derivatives Disclosures (ASB 1998)
December	Report by Strategy Working Party: Shaping IASC for the Future (IASC 1998b)		
	IAS 39: Financial Instruments: Recognition and Measurement (IASC 1999)		

A4: Comparing project documents

Over the years, accounting guidance proposed within the IASC's project on financial instruments as well as related documents by other standard setters gained in volume and complexity. To compare the essence of the guidance contained in the major project documents at different points in time, this appendix looks at two major aspects of the emerging accounting guidance. As discussed in more detail in this thesis, recognition and derecognition guidance changed considerably in the course of the financial instruments project. Complementary changes took place in the guidance on measurement subsequent to initial recognition. These changes in recognition and measurement guidance will be discussed in turn.

Recognition and derecognition

In the course of the project, proposed recognition and derecognition criteria underwent substantive changes. The following table A4.1 summarizes the recognition and derecognition guidance specified in the major documents of the IASC project and compares it with two closely related standards by the FASB and the ASB. The changing recognition and derecognition guidance reflects attempts to recapture off-balance sheet financial instruments as accounting objects. It also reflects attempts to accommodate the sizable securitization industry that emerged since the 1980s.

Table A4.1: Criteria for recognition and derecognition

Document	Recognition	Derecognition
IASC Exposure Draft E40 (1991)	**Measurability of risks and rewards:**	**Transfer of risks and rewards:**
	"... when: (a) the risks and rewards associated with the asset or liability have been transferred ...; and (b) the cost or value of the asset ... or amount of the obligation assumed can be measured reliably." (par. 15)	"... when: (a) the risks and rewards associated with the asset or liability have been transferred to others; or (b) the underlying right or obligation has been exercised, discharged or cancelled, or has expired." (par. 29)
	Consider: price risk, credit risk, and liquidity risk. (par. 19)	"... is a matter for the exercise of judgment in each situation." (par. 31)
	"... is a matter for the exercise of judgment in each situation." (par. 22)	Consider primary risk as credit risk for receivables. (par. 33)
	Recognition of separate components of a compound financial instrument and accounting "... separately according to their particular characteristics." (par. 25)	

Document	Recognition	Derecognition
IASC Exposure Draft E48 (1994)	**Measurability of risks and rewards:** "... when: (a) substantially all the risks and rewards associated with the asset or liability have been transferred ...; and (b) the cost or value of the asset ... or the amount of the obligation assumed can be measured reliably. (par. 19) Consider: price risk, credit risk, and liquidity risk. (par. 22) Recognition of separate components of a compound financial instrument and accounting "... separately according to their particular characteristics." (par. 40)	**Transfer of substantially all risks and rewards of components:** "... when: (a) substantially all the risks and rewards associated with the asset or liability have been transferred to others and the fair value of any risks and rewards retained can be measured reliably; or (b) the underlying right or obligation has been exercised, discharged or cancelled, or has expired. Financial assets and financial liabilities resulting from retention of risks and rewards should be recognized ..." (par. 27) "Management of the enterprise exercises its judgment in determining whether substantially all of the risks and retained rewards can be measured reliably." (par. 30) Consider primary risk as credit risk for receivables. (par. 32)
ASB FRS 5 (1994)	**Measurability of assets and liabilities:** "... meets definition of asset or liability ... if - (a) sufficient evidence of the item ... (b) ... can be measured at a monetary amount with sufficient reliability." (par. 20)	**Transfer of significant rights and obligations with linked presentation:** "Where a transaction ... transfers ... (a) all significant rights or other access to benefits relating to that asset, and (b) all significant exposure to the risks inherent in those benefits ..." (par. 22) The notion of significant is to be "judged in relation to benefits and risks that are likely to occur in practice" (par. 25). Includes linked presentation for non-recourse transactions (pars. 26-28).
FASB SFAS 125 (1996) (including proposed amendments June 1999)	**Control of assets and liability:** "... only assets [the enterprise] controls and liabilities it has incurred ..." (par. 5)	**Transfer of control:** "... assets only when control has been surrendered, and ... liabilities only when they have been extinguished." (par. 5) Surrender control: "... if and only if all of the following conditions are met: (a) The transferred assets have been isolated from the transferor ... even in bankruptcy or other receivership ... (b) If the transferee is a ... (SPE) ...: (1) The holders of beneficial interests in that entity have the right to pledge or exchange those interests ... (2) The transferor does not retain effective control over transferred assets ... other than through a cleanup call ... (c) If the transferee is not a qualifying SPE: (1) Each transferee obtains the right to pledge or exchange the transferred assets ... (2) The transferor does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity.
IASC Discussion Paper 1997	**Contract:** "... when it becomes a party to the contractual provisions that comprise the financial instrument." (chapter 3, par. 3.1)	**Transfer of control:** "... financial asset (or a portion of a financial asset) ... when the enterprise realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders or otherwise

Document	Recognition	Derecognition
		loses control of the contractual rights that comprise the financial asset ..." (chapter 3, par. 4.1) "... financial liability (or a portion of a financial liability) ... when it is extinguished ..., or when the primary responsibility for the liability (or a portion thereof) is transferred to another party." (chapter 3, par. 4.1) "(a) Control is not surrendered if the transferor can revoke the transfer and essentially put things back the way they were. (b) For control to be surrendered the transferee should have the ability ... to realise the contractual rights ... (c) Control is not transferred if the transferor is entitled or obligated to purchase or redeem the transferred assets at a fixed or determinable price that ... provides the transferee with a rate of return that is equivalent to interest ..." (chapter 3, par. 9.14)
IASC Exposure Draft E62 (1998)	**Contract involving financial instrument:** "... when, and only when, it becomes party to the contractual provisions of the instrument." (par. 22)	**Transfer of control:** Financial asset: "... or a portion of a financial asset when, and only when, the enterprise realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders or otherwise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset)." (par. 25) Control: "... depends both on the enterprise's position and that of the transferee." (par. 26) "(a) if the transferee is free to either sell or to pledge approximately the full fair value of the transferred assets; or (b) ... special purpose entity itself or the holders of beneficial interests in that entity have the ability to obtain substantially all of the benefits of the transferred assets." (par. 29) Control not surrendered: "... (a) ... right to rescind the original transfer without fully compensating the transferee ...; (b) ... both entitled and obligated to repurchase or redeem the transferred assets on terms that effectively provide the transferee with a lender's return ... (par. 27) Derecognition of part of an asset. (par. 31) Asset derecognition with recognition of a new asset of liability. (par. 35) Financial liability: "... or part of a financial liability when, and only when, it is extinguished - that is, when the obligation specified in the contract is discharged, cancelled or expired – or when the primary responsibility for the liability (or a part thereof) is transferred to another party." (par. 40) Derecognition of part of a liability or coupled with a new financial asset or liability. (par. 42)

Document	Recognition	Derecognition
IAS 39 (1998)	**Contract involving financial instrument:** "... when, and only when, it becomes party to the contractual provisions of the instrument." (par. 27) Consideration of trade date accounting and settlement date accounting for regular way trades. (pars. 30-34)	**Transfer of control:** Financial asset: "... or a portion of a financial asset when, and only when, the enterprise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset). An enterprise loses such control if it realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders those rights." (par. 35) Control: "... depends both on the enterprise's position and that of the transferee." (par. 37) "... if the transferee: (a) is free either to sell or to pledge approximately the full fair value of the transferred assets; or (b) is a special purpose entity ... and ... itself or the holders of beneficial interests in that entity have the ability to obtain substantially all of the benefits of the transferred assets." (par. 41) Not lost control: "... (a) ... right to reacquire the transferred asset unless either (i) the asset is readily obtainable in the market or (ii) the reacquisition price is fair value ...; (b) ... both entitled and obligated to repurchase or redeem the transferred assets on terms that effectively provide the transferee with a lender's return ...; (c) ... retained substantially all of the risks and returns of ownership [e.g., total return swap for assets not readily obtainable in the market] ... (par. 38) Accounting for collateral. (par. 44) Derecognition of part of an asset. (par. 47) Asset derecognition with recognition of a new asset of liability. (par. 51) Financial liability: "... or a part of a financial liability when, and only when, it is extinguished - that is, when the obligation specified in the contract is discharged, cancelled or expires. ... (a) ... by paying the creditor ...; or (b) the debtor is legally released from primary responsibility ..." (pars. 57-58) Derecognition of part of a liability or coupled with a new financial asset or liability. (par. 65)

To compare the guidance and understand the differences between the various documents, it may be useful to refer to the conceptual framework, which distinguishes between three aspects of assets and liabilities relating to categories of time. An asset is thus defined as a resource resulting from (i) *past* event (ii) that is (*currently*) controlled by the enterprise from which (iii) *future* economic benefits are expected to flow to the enterprise.[303] A liability is

[303] Refer, for example, to IASC Framework, par. 49.

defined analogously. Over time, the IASC recognition criteria shifted the emphasis from aspect (iii) to aspect (i). At the same time, they came to rely on the definition of assets and liabilities, which comprised the aspects (ii) and (iii) by definition.

The early criteria relied on an assessment about future flows of economic benefits, corresponding to aspect (iii). The guidance that emerged in the U.S., following SFAS 77, was seen to emphasize control, that is, aspect (ii). In contrast, the recognition guidance in FRS 5, while relying on the notions of assets and liabilities rather than just risks and rewards and thus implicitly including all three aspects, still required reliable measurement. Instead, the later guidance by the IASC, following the Discussion Paper 1997, came to rely more on aspect (i). Recognition was to be triggered by becoming party to a contract that gives rise to a financial instrument, thus de-emphasizing reliable measurement. However, as discussed in chapter four, this shifted the judgmental burden to assess flows of future benefits to measurement subsequent to initial recognition.

While in-substance defeasance was disallowed with the publication of E40, the IASC's guidance on derecognition essentially mirrored the provisions for recognition. However, while the recognition criteria became simpler over time, reflecting that recognition of financial instruments became the default option, derecognition criteria became increasingly complex. This was largely due to the need to accommodate the securitization industry. Following the U.S. developments since SFAS 77, derecognition came to rely on transfer of control considering the status of the transferee, for example, the status of a Special Purpose Entity in the case of a securitization.

Measurement subsequent to initial recognition

To compare the IASC guidance on the measurement subsequent to initial recognition in the major documents of the financial instruments project, this section adopts a formal presentation suggested by Stephens et al. (1985). This formal presentation treats accounting rules as grammars of a formal language.[304] In this perspective, the language of accounting

[304] Other attempts at developing a formal description of accounting include, for example, Mattessich (1957) and Willett (1987). Willett (1987) includes a review of this literature, as does Mattessich

can be seen to include a set of primitives as classified accounting representations of economic events and a set of rules for forming combinations of these primitives. The rules result in output sentences corresponding to financial reporting numbers. Accounting standards can thus be seen as a formal grammar of accounting representation subject to professional judgement. As discussed in this thesis, standards are the outcome of regulatory debates which can be seen to demand internal consistency and consistency of standards within the system of other standards.

Analytically, we may consider the accounting practice of classification and representation as a two-stage diagnostic process.[305] The first stage can be seen to involve establishing a meaningful representation e_i of an 'economic' event a_i by capturing and classifying the event in categories that can be translated into accounting representations. To be meaningful, the event needs to be seen as relating to the financial position or performance of the reporting entity. An appropriate event could thus be the entering of a contract or a change in market conditions that are seen to affect the entity. Becoming party to a contract that grants the reporting entity an optional right to buy foreign exchange in the future at a specified price may thus be classified as a financial instrument making the event amenable to accounting guidance. The second stage involves subjecting the representation e_i to an accounting program g_j, resulting in an accounting entry s_i. The rules of the accounting program translate e_i in a way that make s_i the formal accounting representation of the economic event.

In reference to Stephens et al. (1985), the formal accounting grammar can be specified as follows. Let A be the set of all observable economic events $\{a_{i,t}\}$ at the reporting date t. Let F be the set of all grammatical rules $\{f_j\}$. Let S be the set of all possible accounting entries $\{s_{i,t}\}$ at time t. The set E of representations $\{e_{i,t}\}$ at t represents a restricted set of accounting

(1980). Most of these contributions put the emphasis on the axiomatic characteristics of the accounting model, while the approach chosen here is limited to the formal aspects of particular standards.

[305] Stephen et al. (1985) suggest three stages, the two stages mentioned further below followed by a 'decision stage'. Here, we remain concerned with the first two stages, which correspond to the 'diagnostic process' that can be seen to be at the core the professional practice (Abbot 1988). Thus, the formal presentation below can be seen as an expression of the more esoteric dimension of diagnosis mentioned by Abbot (1988, p. 42): "A profession's diagnostic classification system is therefore actually organized not as a logical hierarchy from the general to the specific, but as a probabilistic hierarchy from the common to the esoteric. As it moves towards the esoteric, however, the system becomes more and more logically structured."

representations of economic events, namely those that are 'meaningful' and appropriate to be represented according to the first stage of the accounting diagnosis. As we have discussed in this thesis, a challenge in accounting regulation seems to be to assure that $e_{i,t}$ can be seen to correspond to $a_{i,t}$ in a *meaningful* way. For instance, in chapter five we discussed the interpretation of observed changes in the rates of interest - an event $a_{i,t}$ - and the relevance of this event for accounting. The change in interest rates might be interpreted as a meaningful accounting event or it may be disregarded for accounting. Even if it is accepted as meaningful for accounting, it might be interpreted differently, for instance, with respect to income. Depending on the interpretation of the event and its perceived relevance for accounting, different notions of appropriateness of accounting representations were seen to prevail.

Formally, the second step of the accounting diagnostic classification can be thought of as an application of a grammar $f_j \in F$ to the representation $e_{i,t}$ of the economic event $a_{i,t}$ to result in an accounting entry $s_{i,t}$. This can be represented as $f_j: e_{i,t} \rightarrow s_{i,t}$. While any grammar $f_z \in F$ could be applied to the representation $e_{i,t}$ to result in an accounting entry $s_{z,t}$, general accounting conventions seem to restrict the possible grammar sets. Some of these accounting conventions are more formal, for example the requirement to maintain the fundamental accounting equation through double-entry bookkeeping. At any point in time t, an appropriate grammar set (G_t, $G_t \subset F$) can be seen to limit accounting to those f_j that are in line with the prevailing notions of appropriateness of accounting representations. The f_j that are members of the subset G_t can be denoted as g_{tj}.

In the course of the financial instruments project the grammar set G_t suggested by the proposed guidance was seen to undergo several changes ($G_t \neq G_{t-1}$). Furthermore, with the emergence of the notion of 'financial instrument', the relevant set of accounting representations E of economic events changed. Initially certain economic events, such as 'becoming party to a futures contract', were not seen to be relevant for recognition and thus did not come to find a representation in financial accounting. Some events thus remained off-balance sheet instruments and, as notions of financial assets and liabilities emerged, became gradually included within the set of primitives as items that should be represented in

accounting and should be subjected to a grammar.

The following illustrates the changes in the related grammar in reference to the more important documents in the IASC project. The illustration is restricted to the aspect of measurement and income reporting after initial balance sheet recognition, which was also looked at in more detail in chapter four.

IASC Draft Statement of Principles and Exposure Draft E40

The IASC's Draft Statement of Principles on Financial Instruments, issued in 1990, and the subsequent Exposure Draft E40, issued in 1991, are rather similar with respect to the suggested guidance on measurement subsequent to initial recognition. The main difference was the explicit distinction between 'benchmark guidance' and 'allowed alternative', which was a result of the discussions leading to E40. We will therefore look here at E40.

Primitives

$e_{i,t} \equiv$ value change between date t and $t-1$ of financial instrument B_i

$B_i = \{B_i \in B_{kmnpq} | k = 0; m,n,q \in \{0,1,2\}; p \in \{0,1\}\}$

$$k = \begin{cases} 1 & \textit{if} \text{ subject to IASs 19, 26, 27, 28, 31; employee stock option} \\ & \quad \text{or commodity contract} \\ 0 & \textit{otherwise} \end{cases}$$

$$m = \begin{cases} 2 & \textit{if} \text{ asset} \\ 1 & \textit{if} \text{ liability} \\ 0 & \textit{otherwise} \text{ (equity instrument)} \end{cases}$$

$$n = \begin{cases} 2 & \textit{if} \text{ hedging instrument} \\ 1 & \textit{if} \text{ investing and financing instrument} \\ 0 & \textit{otherwise} \text{ (operating instrument)} \end{cases}$$

$$p = \begin{cases} 1 & \textit{if} \text{ fixed maturity amount} \\ 0 & \textit{otherwise} \end{cases}$$

$$q = \begin{cases} 2 & \textit{if} \text{ hedge of OBS commitment} \\ 1 & \textit{if} \text{ hedge of investing and financing instrument} \\ 0 & \textit{otherwise} \end{cases}$$

$V_{i,t} \equiv$ fair value (also 'recoverable amount') of B_i at date t

$s_{i,t-1} \equiv$ opening book value of B_i at date $t-1$

$s_{i,t_0} \equiv$ historical value of B_i at date t_0

$$\Delta_{h,t} \equiv \begin{cases} \text{change in book value of hedged item} & \text{if } (q=1) \\ \text{change in fair value of hedged item} & \text{otherwise} \end{cases}$$

an output of other grammars

$I_t^a \equiv$ net income before considering $e_{i,t}$, an output of other grammars

$o_{i,t} \equiv$ amortised value of $B_i = \{B_i \in B_{kmnpq} | k, q = 0; m \in \{1,2\}, n = 1; p = 1\}$

In E40, the accounting representation of the event $e_{i,t}$ involved a number of categories denoted as k, m, n , p and q. Definitions of these categories took up much of the proposed accounting guidance. Some important and more controversial categories included, for example:

$m = 1$ As specified in paragraph 40 of E40, an instrument for which the issuer had the obligation to settle was to be classified as a liability. When distinguishing between liability and equity instruments, it was proposed that substance should prevail over legal form (par. 38) and that components of compound instruments should be separated (pars. 25-28).

$n = 1$ Investing and financing instruments (pars. 64-71) required both the *intention* to hold for long term or until maturity as well as the *ability* to hold for the long term. In E40, investing and financing instruments *could not* be derivatives (par. 66). Derivatives needed to be classified as either hedging or operating instruments.

$n = 2$ Hedging instruments required all of the following characteristics (pars. 92-103): (1) the hedged item had to be a broadly identifiable position, both recognized and unrecognized, which exposed the entity to risk of loss as a result of adverse price changes; (2) fair value changes had to be measurable and offsetting with high correlation; (3) hedging relationship had to be designated based on management intend (also after inception).

Furthermore, E40 specified that the amortized value should be based on the effective yield of an instrument prevailing at its inception.

Grammatical rules (benchmark)

$$s_{i,t} = \begin{cases} s_{i,t-1} + (V_{i,t} - V_{i,t-1}) - \Delta_{h,t} & \text{if } (n=2) \cap (q=2) \\ s_{i,t-1} - \Delta_{h,t} & \text{if } (n=2) \cap (q=1) \\ \min\{V_{i,t}, o_{i,t}\} & \text{if } (n=1) \cap (m=2) \cap (p=1) \\ \min\{V_{i,t}, s_{i,t_0}\} & \text{if } (n=1) \cap (m=2) \cap (p=0) \\ o_{i,t} & \text{if } (n=1) \cap (m=1) \cap (p=1) \\ V_{i,t} & \text{if } (n=0) \cup ((n=2) \cap (q=0)) \\ s_{i,t_0} & \text{otherwise} \end{cases}$$

$$I_t^p = I_t^a + s_{i,t} - s_{i,t-1}$$

Grammatical rules (allowed alternative)

$$s_{i,t} = \begin{cases} s_{i,t-1} + (V_{i,t} - V_{i,t-1}) - \Delta_{h,t} & \text{if } (n=2) \cap (q=2) \\ V_{i,t} & \text{otherwise} \end{cases}$$

$$I_t^p = I_t^a + s_{i,t} - s_{i,t-1}$$

In case the fair value of an instrument may not be reliably measured, the benchmark treatment was to be applied. Offsetting value changes of instruments that were held by the same counter-party was allowed as long as there was evidence of both, a legal right *and* the intention to offset (pars. 51-56).

Output Sentences

$s_{i,t} \equiv$ closing book value of financial instrument B_i

$I_t^p \equiv$ net income after considering $e_{i,t}$

Comment

E40 proposed a clean surplus accounting model, with all value changes reported in the income statement either when remeasuring the instrument subsequent to initial recognition or when derecognizing the instrument. The benchmark guidance under E40 relied on a classification of instruments according to management intent. It proposed fair value measurement only for specified classes of instruments, namely operating instruments and certain hedging instruments. Investing and financing instruments were to be accounted for by using either the historical book value or the amortized value under historical yield to

maturity, subject to a fair-value impairment test. The proposed measurement guidance thus reported instruments depending on management intent at fair value, amortized value or historical value.

IASC Exposure Draft E48

The exposure draft E48, issued in 1994, did not depart substantially from E40. It relied on most of the classifications proposed by E40, but re-labeled and broadened some of the categories. For instance, it replaced the investing and financing category by a long-term or held-to-maturity category. E48 also explicitly considered uncommitted future transactions as hedged items.

Primitives

$e_{i,t} \equiv$ value change between date t and $t-1$ of financial instrument B_i

$B_i = \{B_i \in B_{kmnpq} | k = 0; m,n,q \in \{0,1,2\}; p \in \{0,1\}\}$

$$k = \begin{cases} 1 & \textit{if} \text{ subject to IASs 19, 26, 27, 28, 31; employee stock option;} \\ & \quad \text{commodity contract or insurance contract} \\ 0 & \textit{otherwise} \end{cases}$$

$$m = \begin{cases} 2 & \textit{if} \text{ asset} \\ 1 & \textit{if} \text{ liability} \\ 0 & \textit{otherwise} \text{ (equity instrument)} \end{cases}$$

$$n = \begin{cases} 2 & \textit{if} \text{ other hedging instrument} \\ 1 & \textit{if} \text{ long - term or held to maturity} \\ 0 & \textit{otherwise} \text{ (operating instrument)} \end{cases}$$

$$p = \begin{cases} 1 & \textit{if} \text{ fixed maturity amount} \\ 0 & \textit{otherwise} \end{cases}$$

$$q = \begin{cases} 2 & \textit{if} \text{ hedge of anticipated exposure} \\ 1 & \textit{if} \text{ hedge of investing or financing instrument} \\ 0 & \textit{otherwise} \end{cases}$$

$V_{i,t} \equiv$ fair value (also recoverable amount) of B_i at date t

$s_{i,t-1} \equiv$ opening book value of B_i at date $t-1$

$s_{i,t_0} \equiv$ historical book value of B_i at date t_0

$$\Delta_{h,t} \equiv \begin{cases} \text{change in book value of hedged item} & \textit{if } (q=1) \\ \text{change in fair value of hedged item} & \textit{otherwise} \end{cases}$$

an output of other grammars

$I_t^a \equiv$ net income before considering $e_{i,t}$, an output of other grammars

$o_{i,t} \equiv$ amortised value of $B_i = \{B_i \in B_{kmnpq} | k,q = 0; m \in \{1,2\}, n = 1; p = 1\}$

The representation of the accounting event $e_{i,t}$ involved categories similar to those in E40, denoted as k, m, n, p and q, with some formal and some substantial differences:

$n = 1$ E48 re-labeled the investing and financing category to become 'instruments held for long-term or to maturity' (pars. 64-71). As in E40, it required *intention* as well as the *ability* to hold for long term or until maturity. However, instruments thus classified *could be* derivatives as well (par. 91).

$n = 2$ In addition to the provisions of E40, E48 allowed to subdivide an enterprise when it seemed impractical to assess financial risk for the enterprise as a whole.

$q = 2$ Instead of allowing hedging instruments for committed transactions only, E48 allowed hedges for uncommitted anticipatory transactions that were 'highly probable'. This, however, excluded purely strategic exposures (pars. 144-146).

Grammatical rules (benchmark)

Same as E40

Grammatical rules (allowed alternative)

Same as E40

Output Sentences

Same as E40

Comment

The widened scope for hedge accounting in E48 reflected attempts by the IASC to accommodate concerns of preparers with regard to hedge accounting. Otherwise, apart from changes in classification it did not substantially depart from the guidance proposed in E40.

IASC Steering Committee Discussion Paper 1997

The Discussion Paper, published by the IASC Steering Committee in 1997, departed fundamentally from the previous attempts to tackle measurement subsequent to initial

recognition. As it did not rely on classification of instruments by management intent, the guidance was simpler than in the previous exposure drafts. For hedge accounting, the Discussion Paper suggested two alternatives (options 1 and 2). One option was to report the fair value changes of the hedge in other comprehensive income and recycle them on recognition of the hedged item. The other option was to report fair value changes of the hedge in a separate line of the income statement and to provide additional disclosures.

Primitives

$$e_{i,t} \equiv \text{value change between date } t \text{ and } t-1 \text{ of financial instrument } B_i$$

$$B_i = \{B_i \in B_{kmn} | k = 0; m \in \{1,2\}, n \in \{0,1\}\}$$

$$k = \begin{cases} 1 & \textit{if } \text{subject to IASs 19, 26, 27, 28, 31; employee stock option; insurance} \\ & \quad \text{contracts; physical delivery commodity contract} \\ 0 & \textit{otherwise} \end{cases}$$

$$m = \begin{cases} 2 & \textit{if } \text{asset} \\ 1 & \textit{if } \text{liability} \\ 0 & \textit{otherwise } (\text{equity instrument}) \end{cases}$$

$$n = \begin{cases} 2 & \textit{if } \text{hedge of investment in foreign entity (cf. IAS 21)} \\ 1 & \textit{if } \text{hedge of anticipated transaction} \\ 0 & \textit{otherwise} \end{cases}$$

$$V_{i,t} \equiv \text{fair value of } B_i \text{ at date } t, \text{ an output of other grammars}$$

$$s_{i,t-1} \equiv \text{opening book value of } B_i \text{ at date } t-1$$

$$I_t^a \equiv \text{net income before consideration } e_{i,t}, \text{ an output of other grammars}$$

$$OCI_t^a \equiv \text{other comprehensive income before consideration of } e_{i,t}, \text{ an output of other grammars}$$

The accounting representation $e_{i,t}$ involved fewer categories than in either E40 or E48:

$m = 1$ Liabilities were defined along the lines of IAS 32, which in this respect followed straight from E48. While own equity instruments were explicitly excluded from the standard, liability components of compound instruments that included equity components had to be accounted for separately. Meanwhile, as measurement guidance was to be symmetrical, the distinction between asset and liability did not matter in this respect.

$n = 1$ Resulting from the change in the proposed recognition guidance, the category of unrecognized *committed* future transaction, to which previous guidance still referred to, was effectively eliminated. The commitment had to be recognized as a separate financial instrument (chapter 3, par. 3.14). Hedging instruments for *uncommitted* anticipated transactions (chapter 7, par. 4.9) became subject to a number of restrictions. These included: formal documentation; consistency with enterprise risk management; expectation of effectiveness; and probable exposure to cash flow risk. Furthermore, to obtain the effect of hedge accounting, the hedged item should *not* be measured at fair value subsequent to initial recognition (chapter 7, par. 4.39). This applied similarly to hedges for non-financial items usually not at fair value.

$n = 2$ Hedging instruments for exposures deriving from assets in foreign entities had to be excluded and dealt with separately in IAS 21.

As discussed in more detail in chapter four, guidance on how to establish fair value was to be addressed in specific future guidance.

Grammatical rules (option 1)

$$s_{i,t} = V_{i,t}$$

$$I_t^P = \begin{cases} I_t^a & if\ (n=1) \\ I_t^a + s_{i,t} - s_{i,t-1} & otherwise \end{cases}$$

$$OCI_t^P = \begin{cases} OCI_t^a + s_{i,t} - s_{i,t-1} & if\ (\mathrm{n}=1) \\ OCI_t^a & otherwise \end{cases}$$

Other comprehensive income and non-owner movements in equity were to be recycled to income (cf. IAS 21).

Grammatical rules (option 2)

$$s_{i,t} = V_{i,t}$$

$$I_t^P = I_t^a + s_{i,t} - s_{i,t-1}$$

In this case, income recognition on hedges of future transactions became a separate line item with additional disclosures in the notes.

Output Sentences

$s_{i,t} \equiv$ closing book value of financial instrument B_i

$I_t^P \equiv$ net income after considering $e_{i,t}$

$OCI_t^P \equiv$ other comprehensive income after considering $e_{i,t}$

Comment

The guidance proposed in the IASC's Steering Group Discussion Paper departed from the mixed models proposed in E40 and E48. All financial instruments within its scope had to be presented at fair values on the face of the balance sheet irrespective of their intended use. Value changes had to be realized as they occurred, except for option 1, which allowed keeping value changes in a separate section of equity called 'other comprehensive income'. The paper did not deal with the techniques that would allow reliable measurement, relegating them to future guidance yet to be developed.

IASC Exposure Draft E62

The exposure draft E62, which was published in 1998, returned to a mixed measurement model. However, compared to IASC's earlier exposure drafts, E62 was limited to enterprises whose equity or debt securities were or were going to be publicly traded (par. 1). As discussed in more detail in chapter four, E62 came to commend the recognition criteria first proposed in the 1997 Discussion Paper. For hedging, it adopted the notion of cash flow hedges. Reliably measurable embedded derivatives, which were not closely related to their host instrument, had to be accounted for separately.

Primitives

$e_{i,t} \equiv$ value change between date t and $t-1$ of financial instrument B_i

$B_i = \{B_i \in B_{kmnpqr} | k = 0; m \in \{0,2\}; n \in \{0,1,2,3,4\}; p,r,u \in \{0,1\}; q \in \{0,1,2\}\}$

$$k = \begin{cases} 1 & \textit{if} \text{ subject to IASs 19, 26, 27, 28, 31; employee stock option; insurance contracts} \\ & \quad \text{physical delivery commodity contract; mortgage, L/C, similar commitments} \\ 0 & \textit{otherwise} \end{cases}$$

$$m = \begin{cases} 2 & \textit{if} \text{ asset} \\ 1 & \textit{if} \text{ equity (excluded)} \\ 0 & \textit{otherwise} \text{ (liability)} \end{cases}$$

$$n = \begin{cases} 4 & \textit{if} \text{ held to maturity} \\ 3 & \textit{if} \text{ fair value not reliably measured} \\ 2 & \textit{if} \text{ hedging instrument} \\ 1 & \textit{if} \text{ trading instrument} \\ 0 & \textit{otherwise} \text{ (no derivative)} \end{cases}$$

$$p = \begin{cases} 1 & \textit{if} \text{ fixed maturity amount} \\ 0 & \textit{otherwise} \end{cases}$$

$$q = \begin{cases} 2 & \textit{if} \text{ hedge of net investment in foreign entity (cf. IAS 21)} \\ 1 & \textit{if} \text{ cash flow hedge} \\ 0 & \textit{otherwise} \text{ (fair value hedge)} \end{cases}$$

$$r = \begin{cases} 1 & \textit{if} \text{ derivative} \\ 0 & \textit{otherwise} \end{cases}$$

$$u = \begin{cases} 1 & \textit{if} \text{ all fair value changes reported in income} \\ 0 & \textit{otherwise} \end{cases} \Bigg| \; u \text{ the same for } \forall B_i$$

$V_{i,t} \equiv$ fair value of B_i at date t

$s_{i,t-1} \equiv$ opening book value of B_i

$s_{i,t_0} \equiv$ historical book value of B_i

$$\Delta_{h,t} \equiv \begin{cases} \text{change in book value of hedged item} & \textit{if } (q = 2) \\ \text{change in fair value of hedged item} & \textit{otherwise} \end{cases}$$

an output of other grammars

$I_t^a \equiv$ net income before $e_{i,t}$, an output of other grammars

$E_t^a \equiv$ equity before $e_{i,t}$, an output of other grammars

$o_{i,t} \equiv$ amortised cost of B_i using effective interest method

The major changes in categories in E62 related to the following:

$m = 0$ Liabilities came to be defined as a residual category resulting from the definition of equity.

$m = 1$ Equity as defined in E62 was to be excluded from the proposed standard (par. 15).

$n = 0$ The default class, which excluded derivatives, had to be measured at fair value subsequent to initial recognition, except for liabilities.

$n = 1$ For the purpose of measurement subsequent to initial recognition, any derivative instrument not classified as a hedging instrument was to be a trading instrument.

$n = 2$ Hedging instruments required all of the following characteristics (pars. 86-89): (1)

hedged item had to be a single asset, liability, firm commitment or forecasted transaction or component thereof, or portfolio of above with similar risk characteristics and reliably measurable; (2) fair value changes needed to be reliably measurable and offsetting specific risks with high effect under documented assessment method; (3) there had to be a formal documentation of the hedging relationship; (4) held-to maturity held at amortized cost could not be used as hedges for interest rate risk.

$n = 3$ Not reliably measurable was defined as 'significant variability in fair value estimates' (pars. 63-66).

$n = 4$ The previously rather broad long-term and investing category was limited to held to maturity instruments (par. 16), which required a specified date of maturity, specified amounts before and at maturity date, intention to hold to maturity (par. 51) and positive ability to hold to maturity (par. 53). This category was *not* to include derivatives.

As in the previously proposed guidance, amortized value was based on the effective yield at inception or reclassification respectively.

Grammatical rules

$$s_{i,t} = \begin{cases} \min\{V_{i,t}, o_{i,t}\} & \text{if } (m=2) \cap (n \geq 3) \cap (p=1) \\ \min\{V_{i,t}, s_{i,t_0}\} & \text{if } (m=2) \cap (n=3) \cap (p=0) \\ o_{i,t} & \text{if } (m=0) \cap ((n \geq 3) \cup (n=0)) \\ V_{i,t} & \text{otherwise} \end{cases}$$

$$x_{i,t} = \begin{cases} \max\left\{s_{i,t} - s_{i,t_0}, -\sum_{t_0}^{t} \Delta_{h,t}, 0\right\} & \text{if } \sum_{t_0}^{t} \Delta_{h,t} \geq 0 \\ \min\left\{s_{i,t} - s_{i,t_0}, -\sum_{t_0}^{t} \Delta_{h,t}, 0\right\} & \text{otherwise} \end{cases}$$

$$I_t^p = \begin{cases} I_t^a + (s_{i,t} - s_{i,t-1}) - (x_{i,t} - x_{i,t-1}) & \text{if } (n=2) \cap (q \geq 1) \cap ((r=1) \cup (u=1)) \\ I_t^a & \text{if } (n=0) \cap (u=0) \\ I_t^a + s_{i,t} - s_{i,t-1} & \text{otherwise} \end{cases}$$

$$E_t^p = \begin{cases} E_t^a + x_t - x_{i,t-1} & \text{if } (n=2) \cap (q \geq 1) \cap ((r=1) \cup (u=1)) \\ E_t^a + s_{i,t} - s_{i,t-1} & \text{if } (u=0) \cap ((n=0) \cup ((n=2) \cap (q \geq 1) \cap (r=0))) \\ E_t^a & \text{otherwise} \end{cases}$$

Value changes recognized in equity needed to be recycled on derecognizing the respective instrument or terminating the hedging relationship, thus maintaining clean surplus accounting. Meanwhile, there was no clear guidance as to whether to adopt basis adjustment, or to match the future hedging gain or loss with net profit or loss incurred by the hedged item. Not presented in the above grammatical rules is the reporting of items *hedged* by a fair value hedge. Gains and losses on the hedged item attributable to the risk hedged by a fair value hedge had to adjust the carrying amount of the hedged item with gains and losses reported in income.

Output Sentences

$s_{i,t} \equiv$ closing book value of B_i

$I_t^p \equiv$ net income after considering $e_{i,t}$

$E_t^p \equiv$ equity after considering $e_{i,t}$

Comment

Although E62 reintroduced a mixed model, it moved the accounting guidance conceptually closer to a fair value model, indicated by measuring the residual category at fair value rather than at cost. As more items were becoming reliably measurable, fewer items would be carried at cost. Besides, E62 attempted to narrow the hold to maturity category and to tighten the guidance for reclassifying items. Hedge accounting was allowed for future uncommitted transactions, although fair value changes of the hedge had to be recognized to the degree that the hedging relationship was not seen to be effective.

International Accounting Standard IAS 39

IAS 39 was the standard published after the regulatory debate following the Exposure Draft E62. The resulting differences to E62 were minor, as can be seen from the illustration below.

Primitives

$e_{i,t} \equiv$ value change between date t and $t-1$ of financial instrument B_i

$B_i = \{B_i \in B_{kmnpqr} | k = 0; m \in \{0,1,3\}; n \in \{0,1,2,3,4,5\}; p,r,u \in \{0,1\}; q \in \{0,1,2\}\}$

$$k = \begin{cases} 1 & \textit{if} \text{ subject to IASs 19, 26, 27, 28, 31; employee stock option; insurance contracts} \\ & \quad \text{physical delivery commodity contract; mortgage, L/C, similar commitments} \\ 0 & \textit{otherwise} \end{cases}$$

$$m = \begin{cases} 3 & \textit{if} \text{ asset} \\ 2 & \textit{if} \text{ equity (excluded)} \\ 1 & \textit{if} \text{ liability settled in unquoted equity} \\ 0 & \textit{otherwise} \text{ (other liability)} \end{cases}$$

$$n = \begin{cases} 5 & \textit{if} \text{ loan or receivable originated by entity} \\ 4 & \textit{if} \text{ held to maturity} \\ 3 & \textit{if} \text{ fair value not reliably measured} \\ 2 & \textit{if} \text{ hedging instrument} \\ 1 & \textit{if} \text{ trading instrument} \\ 0 & \textit{otherwise} \text{ (available for sale, no derivative)} \end{cases}$$

$$p = \begin{cases} 1 & \textit{if} \text{ fixed maturity amount} \\ 0 & \textit{otherwise} \end{cases}$$

$$q = \begin{cases} 2 & \textit{if} \text{ hedge of net investment in foreign entity (cf. IAS 21)} \\ 1 & \textit{if} \text{ cash flow hedge} \\ 0 & \textit{otherwise} \text{ (fair value hedge)} \end{cases}$$

$$r = \begin{cases} 1 & \textit{if} \text{ derivative} \\ 0 & \textit{otherwise} \end{cases}$$

$$u = \begin{cases} 1 & \textit{if} \text{ all fair value changes reported in income} \\ 0 & \textit{otherwise} \end{cases} \Bigg| \; u \text{ the same for } \forall B_i$$

$V_{i,t} \equiv$ fair value of B_i at date t

$s_{i,t-1} \equiv$ opening book value of B_i

$s_{i,t_0} \equiv$ historical book value of B_i

$$\Delta_{h,t} \equiv \begin{cases} \text{change in book value of hedged item} & \textit{if } (q = 2) \\ \text{change in fair value of hedged item} & \textit{otherwise} \end{cases}$$

an output of other grammars

$I_t^a \equiv$ net income before $e_{i,t}$, an output of other grammars

$E_t^a \equiv$ equity before $e_{i,t}$, an output of other grammars

$o_{i,i} \equiv$ amortised cost of B_i using effective interest method

While reliably measurable embedded derivatives, which were not closely related to their host instrument, had to be separated, as in E62, some new categories were introduced:

$m = 1$ Liabilities that were to be settled in unquoted equity.

$n = 0$ This default category of financial instruments came to be called available for sale.

$n = 4$ As compared to E62 the conditions for classification of instruments held to maturity was made more detailed (pars. 79-92) and more restrictive to apply.

$n = 5$ This category was introduced in IAS 39 to cover more traditional financial instruments like receivables and loans originated by the entity. These became excluded from the requirement to be carried at fair value.

Grammatical rules

$$s_{i,t} = \begin{cases} \min\{V_{i,t}, o_{i,t}\} & \text{if } (m=3)\cap(n\geq 3)\cap(p=1) \\ \min\{V_{i,t}, s_{i,t_0}\} & \text{if } (m=3)\cap(n\geq 3)\cap(p=0) \\ s_{i,t_0} & \text{if } (m=1)\cap((n\geq 3)\cup(n=0)) \\ o_{i,t} & \text{if } (m=0)\cap((n\geq 3)\cup(n=0)) \\ V_{i,t} & \text{otherwise} \end{cases}$$

$$x_{i,t} = \begin{cases} \max\left\{s_{i,t} - s_{i,t_0}, -\sum_{t_0}^{t}\Delta_{h,t}, 0\right\} & \text{if } \sum_{t_0}^{t}\Delta_{h,t} \geq 0 \\ \min\left\{s_{i,t} - s_{i,t_0}, -\sum_{t_0}^{t}\Delta_{h,t}, 0\right\} & \text{otherwise} \end{cases}$$

$$I_t^p = \begin{cases} I_t^a + (s_{i,t} - s_{i,t-1}) - (x_{i,t} - x_{i,t-1}) & \text{if } (n=2)\cap(r=0)\cap(((q=1)\cap(u=0))\cup(q=2)) \\ I_t^a & \text{if } (n=0)\cap(u=0) \\ I_t^a + s_{i,t} - s_{i,t-1} & \text{otherwise} \end{cases}$$

$$E_t^p = \begin{cases} E_t^a + x_t - x_{i,t-1} & \text{if } (n=2)\cap(q\geq 1)\cap((r=1)\cup(u=1)) \\ E_t^a + s_{i,t} - s_{i,t-1} & \text{if } ((n=0)\cap(u=0))\cup((n=2)\cap(r=0)\cap(((q=1)\cap(u=0))\cup(q=2))) \\ E_t^a & \text{otherwise} \end{cases}$$

Compared to E62, the guidance on hedges of net investments in foreign entities was made more detailed.

Output Sentences

$s_{i,t} \equiv$ closing book value of B_i

$I_t^p \equiv$ net income after considering $e_{i,t}$

$E_t^p \equiv$ equity after considering $e_{i,t}$

Comment

The substance of IAS 39 was close to the proposed guidance in E62. The main changes related to classification and the detail of the guidance.

A5: Globalizing network

Chapter six summarized certain aspects of the tangible structure of the international regulatory debate on financial instruments. Using abstract measures, this appendix looks at some of these aspects and at the participation of U.K. based constituents in the IASC debate.

By classifying contributors to the main documents of the IASC project by national origin, we can appreciate the links that the IASC debate entertains with actors in the various national jurisdictions. For Canadian constituents the project had more the character of a national project, particularly during the early stages. Canadian contributors are therefore excluded from the tables below. Table A5.1 shows the national origins of contributors to the IASC debate, mostly organizations but also some individuals. The category 'international' includes, among other international organizations and associations, the Big Six respective Big Five accounting firms. The last column indicates that 262 different non-Canadian contributors have sent at least one public comment letter to any of the IASC's major project documents. Less than half of these contributors commented on more than one while one in six contributors contributed at least to three documents. There are around thirty contributors, who submitted comments to at least four of the six major documents (see also table A5.2). Furthermore, the concentration measures Gini(N), based on origin of contributors to the *specific* document, and Gini(30), based on the origin of contributors to *at least one* document, were consistently high. This suggests that the debate mainly recruited contributors from a few countries. Most commentators were either international or originated from the U.K., the U.S. or Australia. A number of Dutch and Japanese contributors submitted almost identical comments to some documents (Discussion Paper and E48 respectively), which explains the relative large number of contributors from these two countries contributing to at least one document. The contributors from these two countries, however, did not sustain this level of involvement.

Table A5.1: National origin of contributors to the IASC debate

No. of contributors to	DSOP 1990	E40 1991	Insight 1992	E48 1994	DP 1997	E62 1998	At least one
Total (excluding Canada)	26	67	12	79	165	112	262
United Kingdom*	3	11	2	8	27	12	37
United States	4	17	4	12	16	11	34
Netherlands	1	2	-	2	24	13	28
Australia	-	8	-	8	13	13	24
International**	5	11	4	11	18	18	23
Japan	1	1	-	17	10	5	22
Switzerland	-	4	-	3	16	8	18
France	1	2	1	2	10	7	15
Germany	1	2	-	1	9	6	11
Hong Kong	1	-	-	1	6	1	7
Italy	1	1	1	1	-	2	5
Belgium	-	1	-	2	3	3	4
Denmark	-	1	-	-	2	3	4
South Africa	1	1	-	3	2	2	4
Sweden	1	1	-	1	3	2	4
Norway	1	-	-	1	1	-	3
India	-	1	-	-	-	1	2
Malaysia	-	-	-	1	1	1	2
New Zealand	-	1	-	1	1	1	2
Pakistan	-	-	-	1	-	1	2
Spain	-	-	-	-	1	1	2
Botswana	-	-	-	1	-	-	1
Finland	-	1	-	-	-	-	1
Kenya	1	-	-	-	-	-	1
Malawi	1	-	-	-	-	-	1
Mexico	-	-	-	1	-	-	1
Portugal	-	-	-	-	1	-	1
Singapore	1	1	-	-	-	-	1
Tanzania	1	-	-	-	-	-	1
Zimbabwe	1	-	-	1	1	1	1
N (countries)	17	18	5	21	20	21	30
Gini(N)	0.31	0.59	0.38	0.60	0.55	0.53	0.62
Gini(30)	0.62	0.76	0.91	0.73	0.71	0.67	0.62

* Includes Ireland
** Includes big audit firms.

The most 'consistent contributors', contributing to at least three IASC documents, are listed in table A5.2.

Table A5.2: Main contributors to international regulatory debate

Main contributors*	Origin	Type
American Institute of Chartered Public Accountants (AICPA)	United States	Professional institute
Arthur Andersen	International	Audit firm
Association for Investment Management and Research (AIMR)	United States	Industry association
Association of British Insurers (ABI)	United Kingdom	Industry association
Australian Accounting Research Foundation (AARF)	Australia	Professional institute
Australian Bankers' Association (ABA)	Australia	Industry association
British Bankers' Association (BBA)	United Kingdom	Industry association
Ciba-Geigy / Novartis	Switzerland	Corporate
Compagnie Nationale des Commissaires aux Comptes (CNC)	France	Professional institute
Coopers & Lybrand	International	Audit firm
Ernst & Young	International	Audit firm
F. Hoffmann-La Roche	Switzerland	Corporate
Federation des Experts Comptable (FEE)	International	Industry association
Financial Accounting Standards Board (FASB)	United States	Standard setter
Financial Executives Institute (FEI)	International	Industry association
Föreningen Auktoriserade Revisorer (FAR)	Sweden	Professional institute
Institut der Wirtschaftsprüfer (IdW)	Germany	Professional institute
Institute of Chartered Accountants of Zimbabwe	Zimbabwe	Professional institute
Institute of Management Accountants (IMA)	United States	Professional institute
International Swaps and Derivatives Association (ISDA)	International	Industry association
Japanese Institute of Chartered Public Accountants	Japan	Professional institute
KPMG	International	Audit firm
PriceWaterhouse	International	Audit firm
Raad voor de Jaarverslaggeving	Netherlands	Standard setter
Securities and Exchange Commission (SEC)	United States	Regulator
South African Institute of Chartered Accountants	South Africa	Professional institute
World Bank	International	Corporate / regulator

* Non-Canadian contributors who submitted written comments to more than three out of the six IASC documents

One third of these 'consistent' contributors were classified as international, including five of the Big Six respective Big Five firms.[306] They also included professional institutes and standard setters from G4 jurisdictions, as well as from France, Germany, Japan, Netherlands Sweden, South Africa and Zimbabwe. Two Swiss corporates were in this group, as were industry associations from Australia, United Kingdom, United States and those classified as international.

[306] Deloitte & Touche, which is not included on this list, nevertheless contributed to the more recent project documents. A partner of Deloitte & Touche, even became involved in the drafting of the actual wording of IAS 39.

The involvement of the large audit firms in the international regulatory debate on financial instruments seems to be even stronger than table A5.2 suggests. The IASC was originally established by professional institutes and during the course of the financial instruments project still operated under the umbrella of IFAC. The strong involvement of professional institutes and their member firms, that is, mainly the large international audit firms, regularly placed the IASC in opposition to national standard setters (Cairns 1997). Only in the course of the financial instruments project, and more so after June 1994, IASC came to involve standard setters in the project.

Table A5.3: Big Five, standard setters and institutes at the IASC Board and in JWG

	Arthur Andersen	Ernst & Young	Deloitte & Touche	KPMG	Pricewaterhouse Coopers	Standard setter	Professional institute
Australia				I	I & J	J	
Canada						I & J	
France				I	J		
Germany					I & J		I
India and Sri Lanka							
Japan			J				
Malaysia							I
Mexico							
Netherlands				I			
New Zealand					J		
Nordic Countries	I & J			I	I		
South Africa and Zimbabwe			I				
United Kingdom						I & J	
United States	J					J	

I - IASC Board
J - Joint Working Group
(as of September 1998)

By 1998, the G4 standard setters became closer associated with the international regulatory debate by becoming involved in the JWG. The primary affiliation of members of the IASC Board and the JWG as of September 1998 is reported in table A5.3. It illustrates that the structure of the international regulatory debate depended strongly on the large audit firms, complemented by G4 standard setters and other professional institutes. Representatives had primary affiliations with four of the Big Five firms. Meanwhile, the stronger involvement of

G4 standard setters in the JWG can be seen as a result of the rift over the Exposure Draft E48 in 1994, as discussed in chapter six.

As mentioned in chapter five, there were particularly strong links between the U.K. debate on financial instruments and the international debate. This may be partly explained by the IASC's physical location, which can be seen to foster informal links between the IASC and U.K. constituents as well as the U.K. profession. The U.K. relationship with the IASC is also peculiar in that David Tweedie, the ASB Chairman, was represented on the Board of the IASC, although officially not as Chairman of the ASB but as the representative of the U.K. profession.

Table A5.4: Participation of U.K. based constituents in international debate

PANEL A

Number of U.K. based constituents including contributors from Ireland		IASC debate No	IASC debate Low*	IASC debate High*	FASB debate**	Total
ASB debate	High***	14	16	10	2	40
	Low***	40	7	1	2	48
	No	3	9	3	3	15
	Total	57	32	14	7	103

* Low (high) participation defined as commenting on less than three (more than two) documents
** Comments to draft of what became SFAS 133
*** Low (high) participation defined as commenting on one (at least two) documents

ASB debate versus IASC debate:	Chitest:	0.000003
	χ^2-statistic:	31.206

PANEL B

Number of contributors from U.K. including Ireland		IASC debate No	IASC debate Yes	Total
ASB debate	High*	14	26	40
	Low*	40	8	48
	Total	54	34	88

Chitest:	0.000004	Error reduction (Goodman and Kru skal):	
χ^2-statistic:	21.362	Lambda (ASB):	0.45
Cramers V:	0.492700	Lambda (IASC)	0.35

* Low (high) participation defined as commenting on one (at least two) documents

Table A5.4 provides some measures of the strengths of the link between the U.K. and the IASC debate on financial instruments. More than a third of the commentators contributing comments to either the ASB Discussion Paper (ASB 1996), the Exposure Draft FRED 13 (ASB 1997a) or the Supplement to FRED 13 (ASB 1997b) also contributed to the IASC

debate. More than one in two of the constituents commenting in the context of the financial instruments debate within the U.K. also commented on the international project. Table A5.4 also notes the number of commentators to what has become SFAS 133. Some U.K. based constituents contributed to the IASC or FASB debate without contributing to the ASB debate. These were mostly banks commenting on recent documents published by the IASC, such as the Discussion Paper 1997, which proposed introducing a fair value model.

A cross tabulation of degree of involvement in the ASB debate and involvement in the IASC debate, detailed in panel B of table A5.4, suggests that higher participation in the U.K. was associated with participation in the international IASC debate. In other words, any U.K. based constituent actively involved in the U.K. debate was significantly more likely to contribute to the IASC debate on financial instruments than a constituent with low participation in the U.K. debate. The lambda measure of error reduction suggests that knowledge of the degree of participation in the ASB debate will reduce the prediction error of participation in the IASC debate by 45%. Likewise, knowledge of participation in the IASC debate will reduce the prediction error of degree of participation by 35%. Meanwhile, the types of contributors involved in the IASC debate suggests that the U.K. contributors to the international debate included the large audit firms, professional associations, industry associations, and large multinational firms rather than other U.K. constituents.

In particular the large audit firms responded to most of the national as well as international documents. In most cases, they did so through their international headquarters (Arthur Andersen, Coopers & Lybrand, Ernst & Young, PriceWaterhouse, and Deloitte & Touche), while responding to the ASB drafts through their national office. Meanwhile, responses from international head offices often involved internal due processes involving the various national offices, in particular those offices that were exposed to international accounting standards, which tended to be Europeans and Asians. Coopers & Lybrand as well as Deloitte & Touche had U.K. national offices attending to the early IASC exposure drafts. They switched to head-office responses with comments on the Exposure Draft E48 and the Discussion Paper 1997 respectively. Throughout the IASC debate KPMG had different national offices responding to the various pronouncements. In the case of E48, this had the

effect that the offices of Australia and Hong Kong each sent separate comments. Lately, KPMG established a new internal structure to deal with the IASC due process from the London office, which also sent the firm's comments to the IASC's 1997 Discussion Paper.[307] While commenting on the early exposure drafts from its U.S. international office, Ernst & Young commented to the later proposals through its U.K. office.

[307] Interview K, July 1998.